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Main Macro Views and Market Strategy:

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- The global recovery, which has been led by Asia and in particular China, has broadened in the second half of 2009 to developed economies with growth in the US and Japan surprising on the upside in Q4, in line with our expectations of a strong initial recovery.

- We expect global growth to remain robust in 2010, though we believe that both leading indicators and quarterly GDP growth will peak in Q1 and flatten later in the year, as monetary and fiscal stimuli will start to fade and the pace of the economic rebound in the US will settle back to a more sustainable path.

- With asset valuations having returned to more normal levels, the powerful cyclical forces that have dominated markets in 2009 will gradually make way to more structural issues in 2010, such as the exit strategies of central banks, the sustainability of public debt dynamics, the regulatory response to the sub-prime crisis, the de-leveraging process of US households and inflationary pressures in EMs from rising commodity prices.

- Excessive public debt in developed countries caused by fiscal accommodation raises concerns about sovereign debt sustainability. Pressure on Greek government bonds may signal the start of a global sovereign debt crisis, which is typical in the aftermath of big financial crises.

- As the recovery gathers pace, we expect effective tightening of monetary policy by major central banks in 2010. The gradual end of QE programs is likely to lead to higher rates along the entire yield curve.

- Government bond yields are expected to increase globally in 2010 as risk appetite returns, Treasury issuance will be high and sovereign debt risk premia increase.

- 2010 marks the comeback of the US dollar as pressures from carry trade strategies abate, sovereign debt concerns in several euro area countries hurt the euro and the US economic growth is likely to outperform both the Eurozone and Japan.

- We remain cautious on equity markets in the short term but expect main indices to head higher in H2, as employment in the US starts to increase, the recovery of economic activity broadens and uncertainty about the timing and the pace of the Fed´s exit strategy dissipates.

Macro Forecasts

Real GDP growth						
	2008	2009	2010f		2011f	
			Eurobank EFG	Consensus	Eurobank EFG	Consensus
US	0.4	-2.4	2.9	2.7 (1.6 – 4.1)	3.0	2.9 (1.8 – 4.6)
Eurozone	0.6	-4.0	1.4	1.2 (0.3 – 2.4)	2.0	1.5 (0.8 – 2.2)
Japan	-0.7	-5.0	1.5	1.4 (0.1 – 1.9)	1.6	1.6 (0.7 – 2.0)
China	9.0	8.7	9.6	9.5 (8.5 – 11.7)	9.0	8.9 (7.2 – 10.0)
India	7.5	7.0	8.0	7.7 (6.8 – 8.2)	8.5	8.1 (7.6 – 8.7)
Russia	5.6	-7.9	4.5	3.2 (1.5 – 5.9)	5.0	4.2 (1.5 – 6.3)
Brazil	5.1	0.2	5.5	4.8 (3.8 – 5.3)	5.0	4.2 (3.0 – 4.6)

Inflation						
			2010f		2011f	
	2008	2009	Eurobank EFG	Consensus	Eurobank EFG	Consensus
US	3.8	-0.3	2.5	2.1 (1.2 – 3.8)	2.6	2.1 (0.9 – 4.8)
Eurozone	3.3	0.3	1.5	1.3 (0.9 – 1.6)	1.6	1.4 (0.8 – 2.0)
Japan	1.4	-1.3	-1.0	-1.3 (-0.8 – -1.8)	-0.5	-0.3 (-1.2 – 0.3)
China	5.9	-0.6	3.0	3.0 (0.7 – 5.5)	3.5	3.8 (3.0 – 4.6)
India (WPI)	8.4	3.4	6.0	6.3 (5.0 – 8.7)	5.5	5.5 (5.5 – 6.0)
Russia	14.1	11.7	9.0	8.5 (6.2 – 11.8)	7.0	8.5 (6.0 – 11.8)
Brazil	5.7	4.3	4.6	4.4 (3.9 – 4.6)	4.5	4.4 (3.9 – 4.5)

Note: Range of forecasts by Bloomberg's survey in parentheses below point estimates.

Policy Rates						
			Eurobank EFG			
	2009	Current	Q1 10f	Q2 10f	Q3 10f	Q4 10f
US	0.00-0.25	0.00-0.25	0.00-0.25	0.00-0.25	0.50	0.75
Eurozone	1.00	1.00	1.00	1.00	1.00	1.25
Japan	0.10	0.10	0.10	0.10	0.10	0.10
China	5.30	5.30	5.30	5.60	5.85	5.85
India	4.75	4.75	4.75	5.00	5.50	6.25
Russia	8.75	8.75	8.50	8.50	8.50	8.50
Brazil	8.75	8.75	8.75	9.25	10.5	11.25

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Executive Summary

The global economy has rebounded from its worst post-war recession, supported by massive fiscal and monetary stimulus. The recovery, which has been led by Asia and in particular China, has broadened in the second half of 2009 to developed economies with growth in the US and Japan surprising on the upside in Q4, in line with our expectations of a strong initial recovery. Looking forward, we expect global economic growth to remain robust in 2010, though we believe that both leading indicators and quarterly GDP growth will peak in Q1 and flatten later in the year, as monetary and fiscal stimuli will start to fade and the pace of the economic rebound in the US will settle back to a more sustainable path.

With asset valuations having returned to more normal levels, the powerful cyclical forces that have dominated markets in 2009 will gradually make way to more structural issues in 2010. Among these issues are the exit strategies of central banks, the sustainability of public debt dynamics, the regulatory response to the sub-prime crisis, the de-leveraging process of US households and inflationary pressures in EMs from rising commodity prices.

As far as the exit strategies are concerned, the big issue is how quickly to withdraw fiscal and monetary stimulus from the economy and which should be withdrawn first. As the recovery in most parts of the developed world is still driven mainly by exports and a temporary inventory re-stocking, while domestic demand remains very weak, it seems that it is too early to initiate a fiscal exit strategy. On the other hand, as financial market conditions have improved substantially over the past twelve months, QE can be rolled back gradually with no significant cost for the real economy. Hence, from an economic perspective, monetary stimulus should be withdrawn first. However, financial markets push for an early exit from fiscal support, as they focus on sovereign risks, considering that with lower economic growth, the accumulated debt burden becomes more difficult to service in the future. Indeed, the pressure on Greek government bonds over the past few months may just signal the start of a global sovereign debt crisis, which is typical in the aftermath of big financial crises.

With economic activity rebounding and subdue inflation, we expect to see effective tightening of monetary policy in most major economies in 2010. We expect the major central banks (Fed, ECB and BoE) to gradually drain excess reserves in the course of the year and start hiking rates by year-end. We expect the Fed to move much more cautiously in tightening policy than the ECB, given that the Fed's QE represents almost entirely outright asset purchases and, consequently, the removal of such unconventional policy stimulus is unlikely to occur without market turbulence.

We expect government bond yields to increase globally in 2010 as higher new issuance meets lower demand for government paper. Expectations of higher short-term rates will also boost the dollar, due to its safe haven status. Indeed, 2010 marks the comeback of the US dollar mainly because the fiscal crisis in the European South weakens the euro. We remain cautious on equity markets in the short term but expect main indices to head higher in H2, as employment in the US starts to increase, the recovery of economic activity broadens and uncertainty about the timing and the pace of the Fed´s exit strategy dissipates.

Dimitris Malliaropulos
Research Advisor

I. Economic Outlook and Asset Allocation

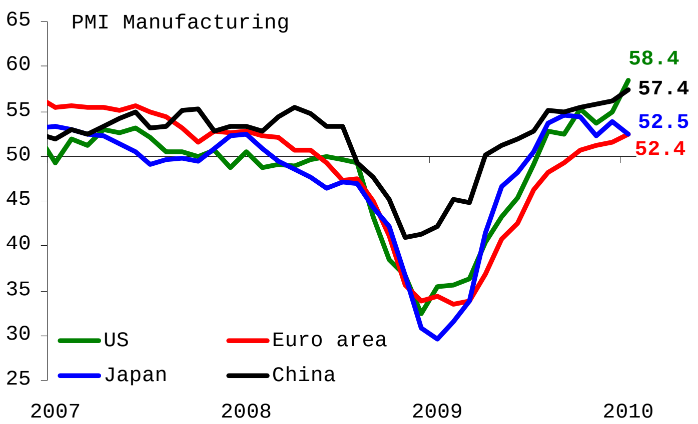
Dimitris Malliaropulos, Maria Prandeka

Global economy: a broad-based recovery

The global economy has rebounded from its worst post-war recession, supported by massive fiscal and monetary stimulus. The recovery, which has been led by Asia and in particular China, has broadened in the second half of 2009 to developed economies with growth in the US surprising on the upside in Q4, in line with our expectations of a strong initial recovery (see our October 2009 issue of Global Economic & Market Outlook). Leading indicators of economic activity continue to show substantial gains. Surveys of manufacturing and business activity, tentatively confirm the substantial improvement, with the ISM manufacturing index registering a stronger than expected reading in January (Figure 1). Our global leading indicator[1], which is designed to capture turning points in economic activity, approximately three months in advance, predicts a strong industrial production recovery (Figure 2). Indeed, the pace of contraction of global industrial production has been easing since May 2009.

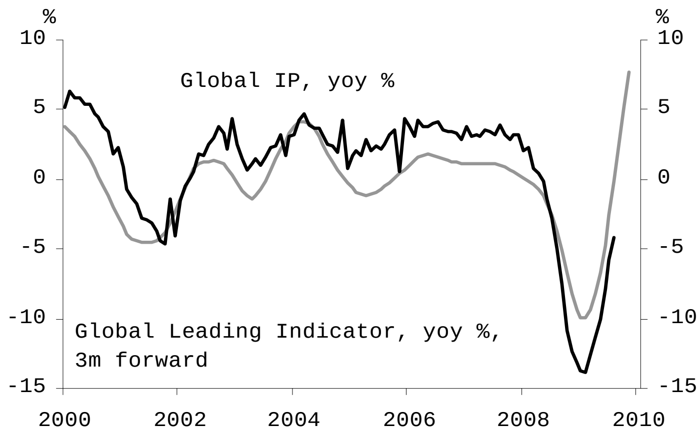
Looking forward, we expect global economic growth to remain robust in 2010, though we believe that both leading indicators and quarterly GDP growth will peak in Q1 and flatten later in the year, as monetary and fiscal stimuli will start to fade and the pace of the economic rebound in the US will settle back to a more sustainable path. Our projections include a significant acceleration of global GDP growth to 4% y-o-y in 2010 from -0.8% y-o-y in 2009, as a synchronised rebound of economic activity will magnify itself, leading to multiplier effects through global trade linkages. The considerable improvement in global growth and manufacturing activity has already fed trough to global trade that has increased by a total of 10% in June-November. According to our analysis, world export growth will have to increase trough-to-peak by more than 20 percentage points, accelerating to a y-o-y growth rate of 10% by 2011, from an estimated contraction of 13% in 2009 (see BOX 1). We believe that most of the rebound in global growth will continue to be fueled by emerging economies, where domestic demand remains resilient and export demand improves significantly.

Figure 1



Source: Bloomberg, Ecowin

Figure 2



Source: OECD, Eurobank EFG estimates

[1] Our global leading indicator is a GDP-weighted average of the OECD Composite Leading Indicators (CLIs) for both developed and developing economies.

Financial markets: rotation from cyclical to structural forces taking place

Reflecting the recovery of the global economy and the massive support of monetary authorities and governments to commercial banks and credit markets, risky asset markets have all bounced higher in one of their strongest rallies since 1933. The Fed has pumped an enormous amount of freshly printed money into the economy to withdraw impaired assets from credit markets, which were in danger of collapsing. The resulting explosion of the Fed´s balance sheet is just the reflection of the fact that large parts of the credit market are still on life support, making a roll-back of the QE program of the Fed a dangerous task. With the balance sheets of financial institutions still suffering from the effects of the sub-prime crisis, it will likely take a long time until the Fed can effectively tighten monetary policy, despite descent economic growth and a gradual stabilization of the labor market in 2010. The reason is, in our view, that much of the tightening of financial conditions in the US in 2010 will be accomplished by the strengthening US dollar, as the fiscal crisis in the European South weakens the euro, and rising Treasury yields, as market concerns about the sustainability of fiscal excesses gradually move across the Atlantic.

The combination of a sustainable recovery of the global economy and super-easy monetary policy will continue to support risky asset markets and commodities in 2010. However, with asset valuations having returned to more normal levels, the powerful cyclical forces that have dominated markets in 2009 will gradually make way to more structural issues in 2010. Among these issues are the exit strategies of central banks, the sustainability of public debt dynamics, the regulatory response to the sub-prime crisis, the de-leveraging process of US households and inflationary pressures in EMs from rising commodity prices.

Exit strategies: Markets push for an early exit from fiscal support

With the great depression having been averted only thanks to massive fiscal and monetary support, the big issue now is how quickly to withdraw fiscal and monetary stimulus from the economy and which should be withdrawn first. As the recovery in most parts of the developed world is still driven mainly by exports and a temporary inventory re-stocking, while domestic demand remains very weak, it seems that it is too early to initiate a fiscal exit strategy. In fact, a premature withdrawal of the fiscal support risks to push the global economy into a double-dip recession. Of course, the cost of delaying a fiscal exit strategy is a waste of resources as fiscal deficits remain high and public debt has risen substantially in all developed economies.

On the other hand, quantitative easing by the central banks, most notably the Fed and the BoE, has led to a flood of excess liquidity, which has supported the banking system and credit markets. As financial market conditions have improved substantially over the past twelve months and liquidity is abundant, quantitative easing can be rolled back gradually with no significant cost for the real economy.

Hence, from an economic perspective, central banks should move first in withdrawing excess liquidity before fiscal policy starts to consolidate. An additional reason is that all this excess liquidity has been channelled into financial markets, pushing up valuations and eventually starting to create new bubbles which may at some point once again threaten to derail the global economy.

However, financial markets seem to think otherwise. The huge amount of excess liquidity pumped into the financial system by central banks and governments has been placed in financial assets, first in government debt, when risky asset markets plunged and investors were looking for safe havens, later in risky assets such as corporate credit, carry trades, equity and commodities, when risk appetite made a comeback. After making sure that the worst is over, financial markets now focus on sovereign risks, as they realise that with lower economic growth, the accumulated debt burden becomes more difficult to service in the future.

Given the Fed´s reluctance to withdraw monetary stimulus before economic conditions fully normalise, financial markets push governments for an early exit from fiscal support. In the meantime, the strengthening of the US dollar and the gradual increase of Treasury yields is doing the job for the Fed by tightening financial conditions in the US economy.

The start of a global sovereign debt crisis?

Viewed from this perspective, the pressure on Greek government bonds over the past few months may just signal the start of a global sovereign debt crisis which is typical in the aftermath of big financial crises. Public debt has increased substantially in all parts of the developed world, as governments rushed to the rescue of banks and initiated large-scale fiscal packages to support the economy. Of course, public debt dynamics threaten to derail first in countries where public debt is already high and chronic imbalances are difficult to cure in the short term, such as in the case of Greece, which suffers from low competitiveness and a high public and external debt burden. The spreading of the Greek public debt crisis to the rest of south European countries suggests that contagion can soon spread to the UK and, eventually, to the US, as investors seem to turn the back to an obviously overpriced global sovereign debt market.

Monetary policy: On the way to a gradual tightening

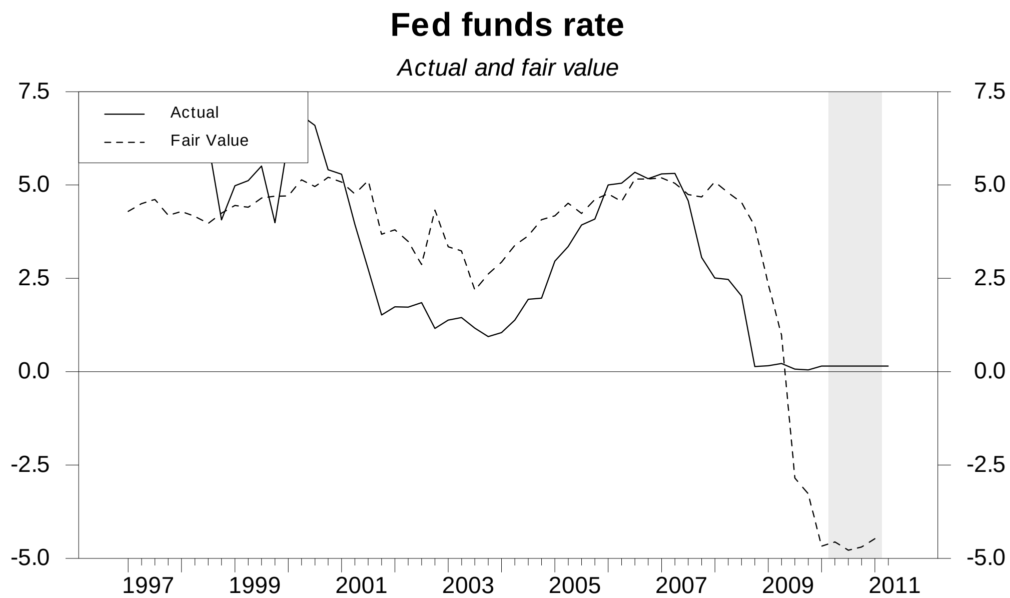
With economic activity rebounding and subdue inflation, we expect to see effective tightening of monetary policy in most major economies in 2010, with the exception of Japan, where deflation is likely to deepen. Central banks of commodity-producing economies (such as Australia) and major emerging economies (such as China and India) have already embarked on a tightening path, as commodity-related pressures on consumer price inflation have intensified in these countries.

We expect the major central banks (Fed, ECB and BoE) to gradually drain excess reserves in the course of the year in line with improving economic conditions and start hiking rates by year-end. The gradual end of QE programs by major central banks in 2010 is likely to lead to higher rates along the entire yield curve, even though we do not expect large-scale outright sales of assets by central banks any time soon. Whereas the roll-back of QE measures does not seem to be a serious issue for the ECB, which has focused on long-term refinancing operations rather than outright purchases of assets, it is a serious concern for the Fed. Given the significant expansion of the Fed´s balance sheet, we believe that the full removal of QE in the US would be equivalent to an increase of Fed Funds rates by roughly 4.5 percentage points. As a result, we expect the Fed to move much more cautiously in tightening policy than the ECB as the removal of such unconventional policy stimulus is unlikely to occur without increasing volatility in both money and credit markets.

Fed: exit strategy is a highly complicated act

After slashing Fed Funds rates to zero in late 2008, the Fed has embarked on a large scale program of asset purchases of MBS and mortgage-related agency debt. These purchases have led to a significant expansion of the Fed´s balance sheet by USD 1.75 trn. The effect of this QE program on interest rates and, consequently, liquidity conditions in the US, is in our view significant, suggesting that the Fed´s exit strategy from QE is a highly complicated act. Based on estimates of our Taylor rule model, the entire QE program of the Fed is estimated to have helped keep real Fed Funds rates 4.5 percentage points below the level they would have been without these asset purchases (Figure 3). Hence, rolling back the Fed´s QE program would translate into a sharp increase in effective real short term rates, threatening the rebound of the economy. As a result, we expect the Fed to maintain its expanded balance sheet for a long time to come and move very gradually towards a normalization of liquidity conditions as the economy recovers and credit markets stabilize.

Figure 3



In our baseline scenario, we expect the Fed to first attempt to drain excess reserves and raise effective Fed Funds rates towards the upper end of its target (25 bps) by applying reverse repos and paying interest on reserves through a term deposit facility. After gaining some control over excess reserves, the Fed will probably start hiking rates by 25 bps in September and December, respectively, and stay on hold for most of the first half of 2011 to assess how markets react, before it embarks on a large-scale tightening.

ECB: phasing out of extraordinary measures

The ECB has already started to gradually roll-back its extraordinary long-term refinancing operations (LTROs) since December 2009. We expect the ECB to let special liquidity facilities phase out by March 31 (except for the regular 3-month operations) and move back to variable rate tenders thereafter. By gradually bringing liquidity conditions back to normal, we expect that EONIA rates will start to move towards the 1% level of the refi rate in Q3. When this happens, the ECB will likely move on to hike rates by 25 bps, probably in December.

Bond market outlook

We expect government bond yields to increase globally in 2010 as higher new issuance meets lower demand for government paper. In addition, the end of Fed purchases of agency debt in March is expected to boost net bond supply, putting upward pressure on bond yields, which will be further intensify as investors price in the approach of Fed tightening. Expectations of higher short-term rates will also boost the dollar, due to its safe haven status. We recommend investors to underweight exposure to US and European bonds across the entire government yield curve and particularly at short maturities, which use to be affected most heavily from a turn in monetary policy. By year-end, we forecast an increase of Treasury yields to 4.5% for the 10-year maturity and 2.4% for the 2-year maturity.

The comeback of the US dollar

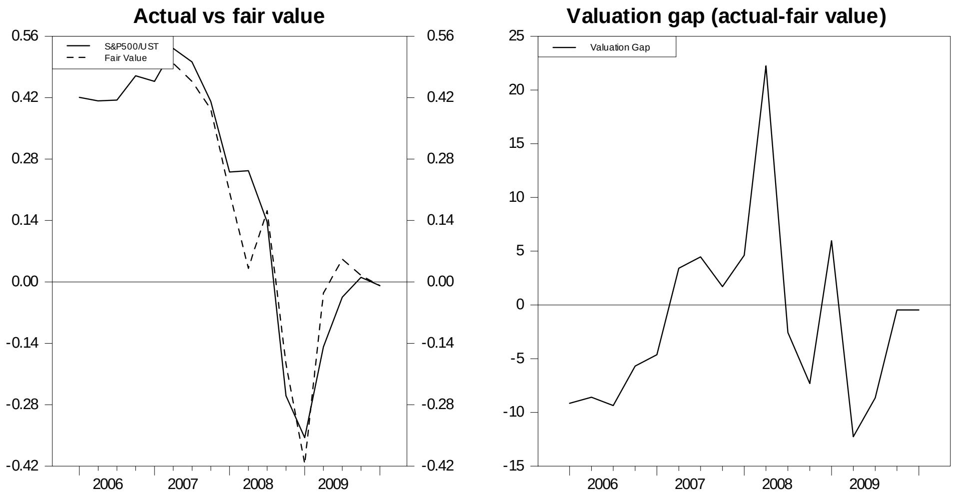
2010 marks the comeback of the US dollar for a number of reasons. First, the dollar has suffered in 2009 as it was widely used as base currency for carry trades against high-yielding commodity-related currencies. With commodities closer to normal valuations, these forces are likely to be much weaker in 2010. Second, market worries about the sustainability of public debt dynamics in Greece and other euro area countries hurt the euro, strengthening the status of the dollar as an international reserve currency. Third, the US is likely to outperform both the euro area and Japan in terms of economic growth. As a result, we expect the EURUSD rate to trend lower to 1.30 within the next three months (currently 1.37) and the USDJPY rate to hit 105 by year-end (currently 90).

Equities: a weak start into the year followed by a sharp rally in H2

The sharp rally of equity markets since March 2009 from one of the worst bear markets on record has led to a considerable multiple expansion, which at the peak of the market, in early January, had already exceeded historical norms derived from the past seven bull markets of the S&P 500. Typically, trailing PEs use to increase by six points during the early stage of a bull market and stock prices increase 42% on average. By early January, trailing PEs had increased by more than 11 points and prices had gained 70% from their trough in early March 2009.

Figure 4

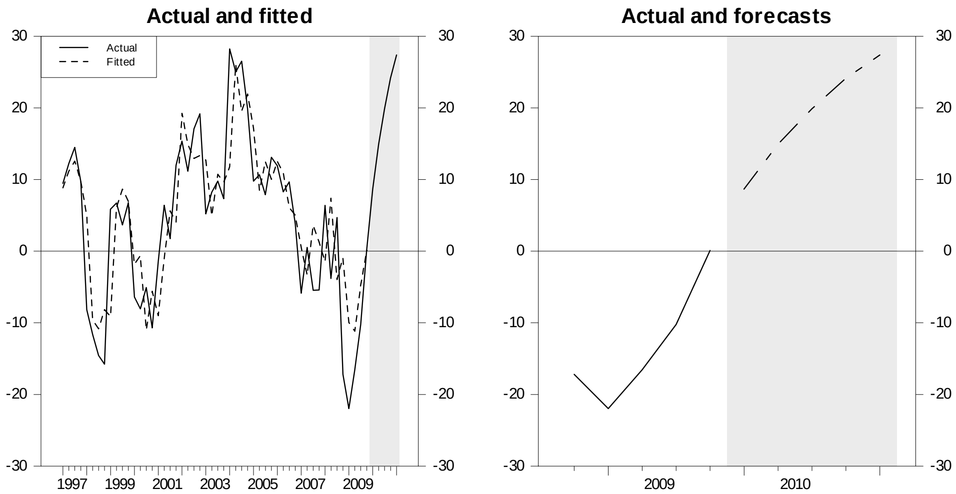
S&P500 relative to US Treasury



In fact, it appears that it is the first time since March 2009 that the relative price of the S&P 500 versus the 10-year US Treasury price index has returned to fair value (Figure 4). With valuations having returned to normal levels, we expect equity markets to be driven mainly by earnings expansion in 2010 and 2011. The sharp rebound of earnings during the second half of 2009 reflected both a base effect, as earnings were coming up from extraordinary low levels, and a significant widening of profit margins, due to cost-cutting and a cyclical increase in productivity, due to a reduction of employment and wage costs. We expect earnings to continue to improve substantially in 2010, supported by the same forces, as unit labor costs will in our view continue to decline due to high unemployment and corporate prices seem to have reversed their downward trend (Figure 5). As a result, we expect economy-wide corporate profits in the US to increase 24% y-o-y in 2010, somewhat lower than the current Consensus estimate of 27% y-o-y growth of S&P 500 earnings (ex financials).

Figure 5

Corporate Profits y-o-y



However, with earnings growth gradually decelerating from its current cyclical highs, inflation picking up from its 2009 (negative) lows and long-term "risk-free" interest rates increasing, we believe that PE multiples are likely to compress in 2010. As we expect the peak in economic activity to occur in Q1:2010, we believe that equity markets have already entered a period of multiple compression, triggered by worries of an early tightening in China and sovereign credit risk in EMU member states. Historical experience from the past seven bull markets of the S&P 500 suggests that this phase of multiple compression lasts six months on average and leads to a correction of equity prices between 10 and 15%. We recommend investors to decrease exposure to cyclical sectors and small caps and overweight defensive sectors and large growth stocks with EM exposure. We expect equity markets to rebound in H2, as employment in the US starts to increase, the recovery of economic activity broadens and uncertainty about the timing and the pace of the Fed´s exit strategy dissipates. Our year-end target for the S&P 500 is 1250, 15% up from current levels.

BOX 1.

In order to estimate the magnitude of the global trade rebound, we examined export growth in a number of major advanced and emerging economies during the main global downturns, as defined by the IMF[2]. The latter identifies four periods during which there was a globally-synchronised recession: 1975, 1982, 1991 and 2009. We also identify 2001 as a year of a global downturn given that many advanced economies suffered a decline in economic activity and world trade almost stalled. Our research suggests that there is a significant correlation between the size of the decline of export growth and the size of the recovery (Figure 6). In order to match historical correlations, world export growth will have to increase by 23.5 percentage points trough to peak, accelerating to 10.5% from an estimated contraction of 13% in 2009. The crucial question is how fast will world exports pick up. Using the World Development Indicators database from the World Bank, we estimate the average behavior of world export growth in the years before and after the previous post-war global downturns. As Figure 7 depicts, world export growth regain most of its ground lost in the following year of a recession, although it takes about 3 years on average for a full recoup to take place. However, in the 1975 episode, when the biggest decline in world exports was recorded, the latter returned to pre-recession levels within 1 year. Therefore, historical experience suggests that global trade is set to accelerate further, shoring up prospects for a strong global economic recovery.

Figure 6

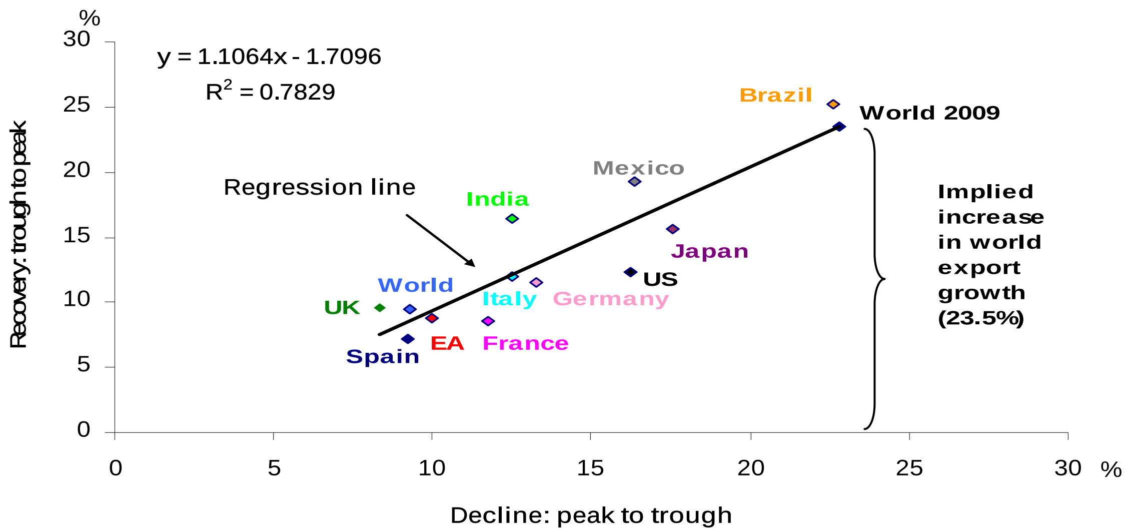
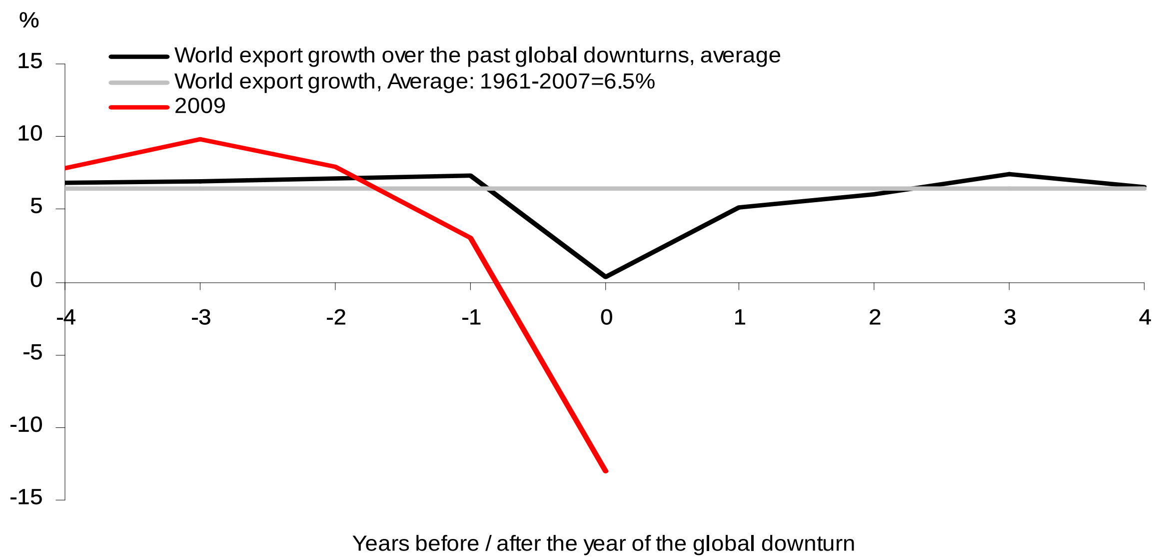


Figure 7



[1] IMF, World Economic Outlook, April 2009

II. Global Economic Outlook

1. The U.S. economy

Dimitris Malliaropulos, Vasilis Zarkos

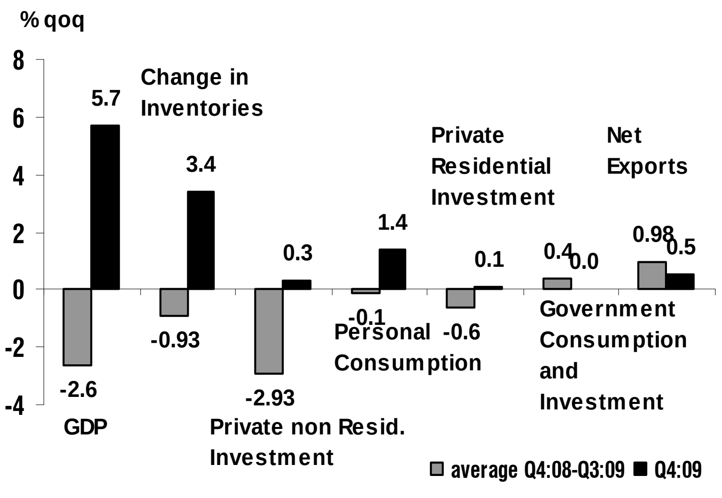
- The U.S. economy has grown for the second consecutive quarter in Q4:09 due to a large swing in inventory liquidation. We expect growth to peak in Q1 and to converge to a lower trajectory for the remainder of the year.
- The U.S. consumer is the risk factor for a sustainable rebound, as unemployment is expected to recede at a quite slow pace.
- We expect subdued headline inflation in 2010. Core inflation will stabilize to lower levels due to modest consumption growth and remaining economic slack.
- The Fed's exit policy is a major concern amplified by the increased uncertainty about the state of the real economy. Choosing the appropriate time to exit will be a major challenge for risky asset markets.

The rebound of economic activity is expected to peak in Q1

U.S. GDP grew by a remarkable 5.7% annual rate in the fourth quarter of 2009, up from 2.2% in Q3, mainly due to a sharp decline in inventory liquidation (Figure 1.1). The fiscal stimulus and monetary easing raised confidence among consumers and markets, supported household income and prevented more painful job cuts. As a result, personal consumption rebounded, giving rise to an increase in industrial production as firms are trying to meet rising demand. Since we saw a decline of inventory liquidation (from -$160bn in Q2:09 to -$33bn in Q4) but no actual rebuilding yet, we expect inventories to continue their positive contribution in H1:10. However, given their cyclical nature, we expect economic growth to peak in Q1 and to recede to a lower trajectory-about 2%-in the remainder of the year.

Figure 1.1

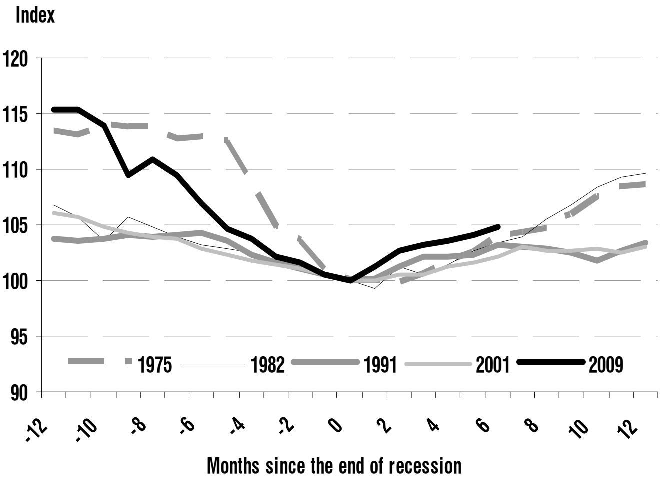
Contributions to Percent Change in Real GDP



Source: U.S. Bureau of Economic Analysis

Figure 1.2

Industrial production rebound compared to previous episodes



Source: Federal Reserve

The Index of Leading Indicators rose 1.1% in December 2009, the ninth consecutive month of increase. The ISM Manufacturing Index jumped to 58.4 in January and exhibits an upward trend since June 2009, illustrating manufacturers' increasing confidence. Industrial production has been increasing for six months in a row since its trough in June. A comparison with previous recessions (Figure 1.2) suggests that industrial production has bounced sharply during the current recovery. Along with rising production, capacity utilization is also exhibiting an increasing trend.

However, the U.S. economy is at the stage of an early recovery with reasons for concern still lingering. As already mentioned, the inventories effect is of cyclical nature. After their impact fades out, final demand will have to support a self-sustainable recovery. In fact, despite the size of fiscal support, the rebound of personal consumption expenditures was not spectacular. Two quarters after the end of the deep recessions of 1975 and 1982, consumption had risen by 3.3% and 1.5% saar, respectively. Assuming that the current recession ended in June 2009, the respective current growth is a meagre 0.17%. Looking forward, household spending will be adversely affected by persistent high unemployment, which, even though it is showing signs of stabilisation, will remain elevated for an extended period of time. Lower real wage growth and uncertainty about future labour market conditions will likely result in a continuing deleveraging of households. It is indicative that the Senior Loan Officer Opinion Survey reveals a decreasing demand for consumer loans.

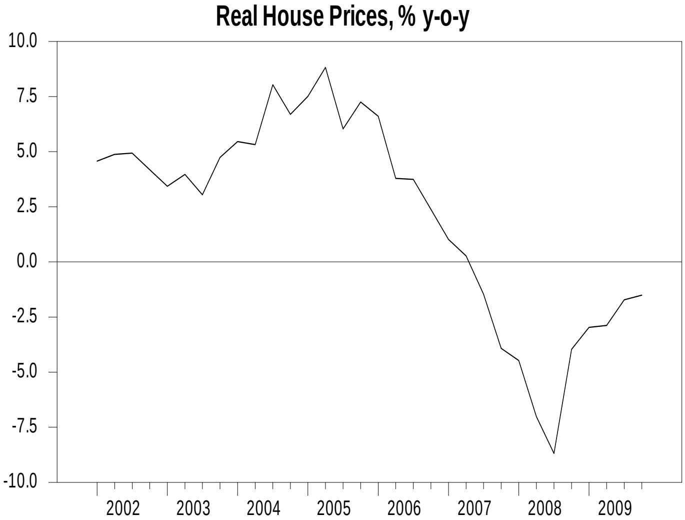
Persistent unemployment and uncertainty about whether consumer spending can be self-sustained call for continuing fiscal aid in 2010. The new home buyer tax credit has been extended until April while according to the president's budget proposal there is an allowance of about $100bn for job boosting measures. However, public debt has climbed to the uncomfortable level of 84.8% with a projection to rise further. Sovereign debt issues have already started attracting the attention of both the administration and financial markets. The government's budget plan projects a reduction of the deficit from 10% in 2009 to 3% in 2020. One of the biggest challenges for the Obama administration ahead is to convince investors that it can achieve fiscal consolidation without putting the economic recovery at risk.

Looking forward, servicing government debt will be more expensive as several factors point to a rise of long term interest rates. First, the Fed's purchase program has increased demand for fixed income assets. When purchases stop, rates will eventually rise. Second, the supply of Treasury notes is expected to remain high in the near term due to persistently high budget deficits. Third, global risk appetite is increasing, leading investors to gradually turn their back to government bonds, thus driving yields higher.

Housing market shows signs of stabilisation but downside risks remain.

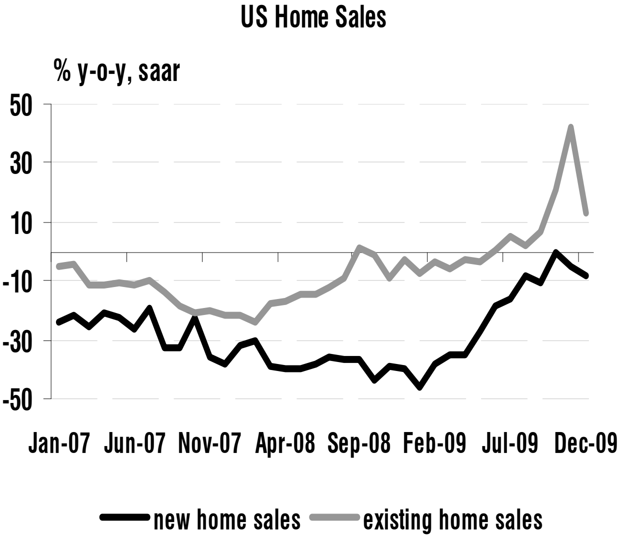
On the positive side for U.S. households, real house prices keep rising (Figure 1.3). New home sales are on a clear upward trend since their trough at the beginning of the year (Figure 1.4), showing signs of stabilization. Existing home sales have rebounded considerably in October and November (21% and 42% y-o-y, respectively). However, we believe these figures were distorted by the rush to take advantage of the homebuyer tax credit program before it expired. The extension of the program until April is expected to further warm the housing sector over the next few months.

Figure 1.3



Source: Federal Housing Finance Agency

Figure 1.4



Source: Census Bureau, Bloomberg

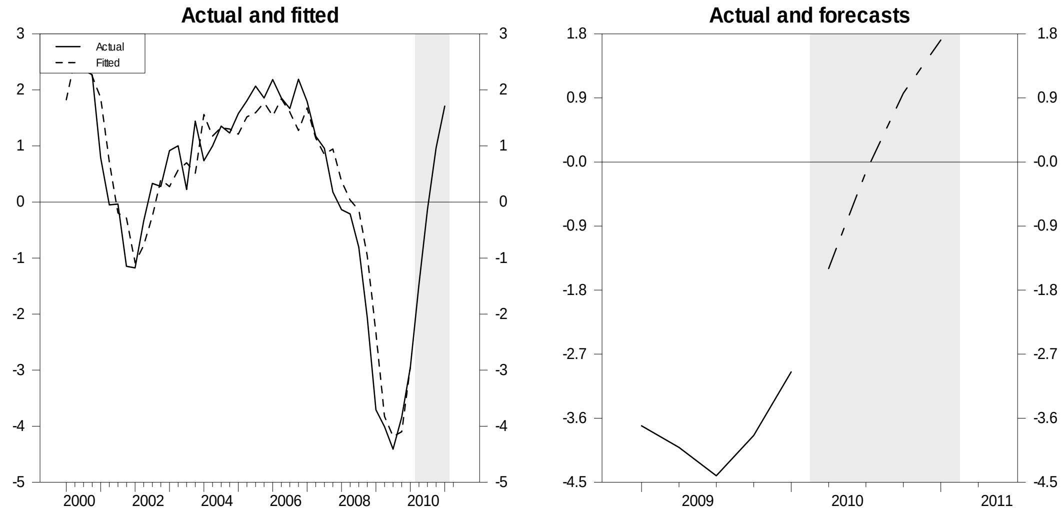
Nonetheless, there are several reasons for concern regarding the stabilization of the housing market. Delinquency rates on single-family residential mortgages keep rising, although at a diminishing pace. Severe labor market conditions may worsen the payment of mortgage installments. Moreover, a major concern comes from the completion of the Fed’s MBS purchase program in March 2010. Due to the program’s large scale, investors may have difficulty in adapting to the shock caused by the Fed’s withdrawal and mortgage rates may move up sharply. Consequently, mortgage loans may become more expensive and delinquency rates may rise even more as adjustable rate mortgages would become even less affordable to borrowers. A glut of foreclosed properties along with better bargains on existing homes has caused an uneven improvement concerning new home sales as opposed to existing ones (Figure 1.4). As a result, residential construction is likely to remain modest, mainly driven by geographical differences in supply. Indeed, confidence among home builders as measured by the National Association of Home Builders is on a declining path in December and January.

Labour market conditions are improving.

On the positive side for the US consumer, labour market conditions seem to be near a turning point. The pace of non-farm payroll losses has stabilized, while unemployment receded to 9.7% in January after it peaked at 10.1% in October. As the recovery gathers pace, job creation will boost employment growth which we expect to turn positive in the second quarter.

Figure 1.5

Civilian Employment y-o-y



Source: Federal Reserve, Eurobank EFG estimates

Even so, we expect a smooth decline of unemployment, which will remain elevated for an extended period of time. The depth of the recent downturn permanently destroyed jobs in the financial, the construction and the automotive sector. Instead, job creation is expected in the education and the healthcare business. The reallocation of workers between sectors will take time and keep unemployment high. Moreover, the Bureau of Labor Statistics reports an increasing number of workers remaining unemployed for more than 27 weeks. The resulting erosion of job skills leads to an increase of structural unemployment.

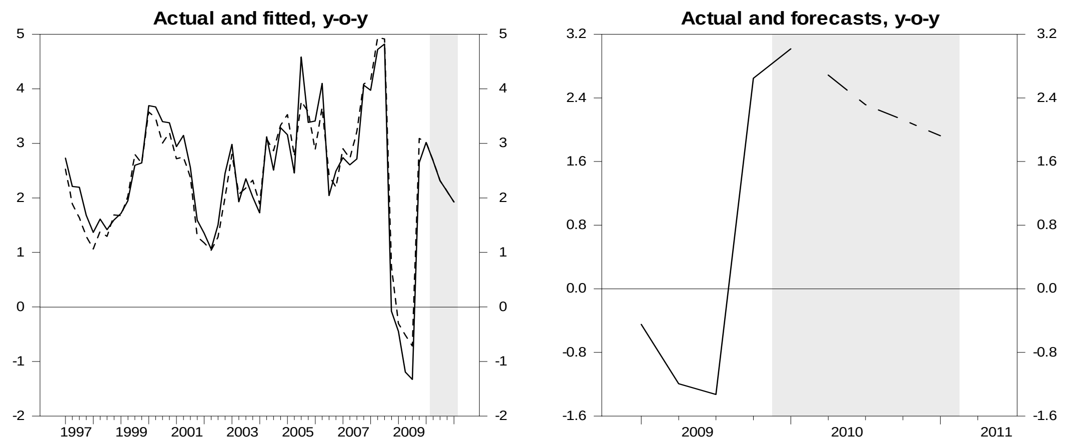
During the crisis, firms addressed reduced demand by slashing hours worked and substantially increasing part time employment. Consequently, manufacturers are expected to first raise hours worked and convert part timers to full time workers before hiring new employees. While leading indicators convey signs of improving conditions in the manufacturing sector, the picture is less favorable for small businesses, which account for about 55% of jobs in the U.S. According to the National Federation of Independent Business, small business hiring plans are discouraging as an increasing percentage of firms report lower earnings and plans for further inventory liquidation. Overall, the duration of unemployment, which has risen form 8.4 weeks at the beginning of the recession to 20.5 last December, is expected to decline quite slowly in 2010.

No concern for inflationary pressures ahead.

Headline inflation is expected to remain subdued for an extended period. Inflation jumped to 2.7% y-o-y in December from 1.8% in November, mainly due to base effects from very low oil prices in the second half of 2008. However, we expect inflation to stabilize to a lower trajectory over the next quarters. As oil prices have more than doubled since the start of 2009, negative base effects of declining energy prices have worn off, eliminating any concerns about deflation.

Figure 1.6

Headline CPI Inflation



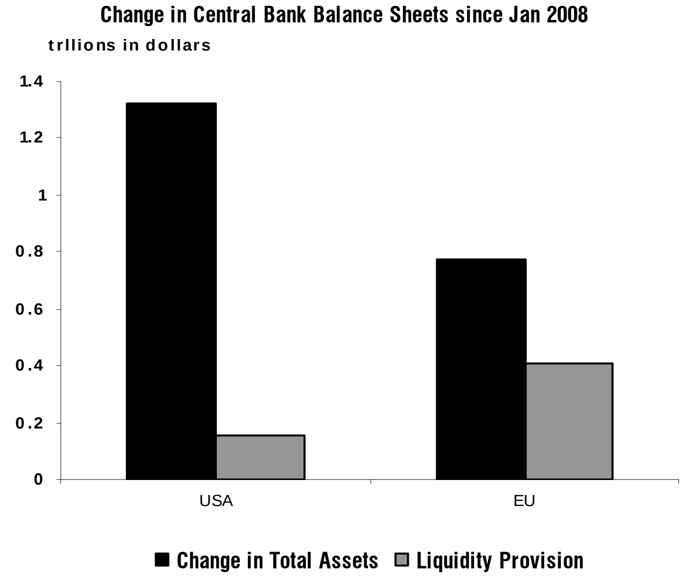
Source: Federal Reserve, Eurobank EFG estimates

Core inflation, which has increased by 1.8% y-o-y in December, is also expected to stabilize to lower levels, due to modest consumption growth and lingering economic slack. High unemployment puts downward pressure on unit labour costs, which we forecast to decline further in 2010. Companies have realised productivity gains through their cost cutting policies during the recession, while low levels of capacity utilization have reduced their pricing power. Hence, we anticipate price pressures to remain subdued.

Fed's exit strategy: a complicated task.

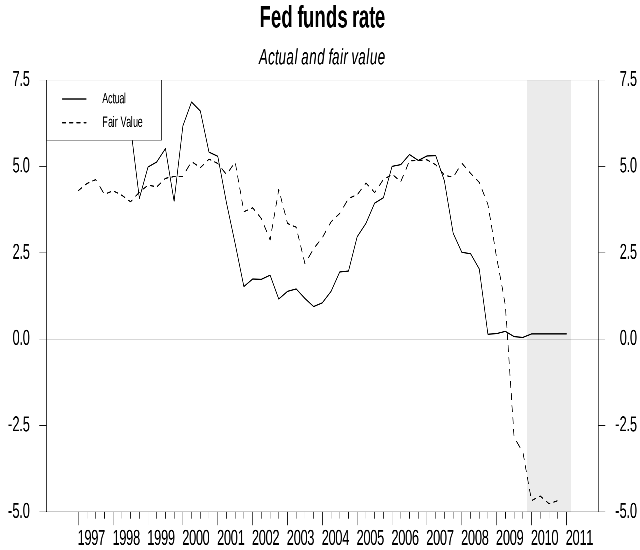
As the economy recovers and financial conditions are improving, the Fed is now focusing on the exit strategy that will start normalizing monetary policy. The big issue is how quickly to withdraw monetary stimulus. A major reason of concern is a policy mistake regarding the Fed's exit strategy. A delayed exit would feed into higher inflation and asset bubbles whereas a premature withdrawal could jeopardize further recovery. The risk of a policy mistake is also higher during turning points of economic activity, as there is higher uncertainty about the state of the real economy.

Figure 1.7



Source: ECB, FED

Figure 1.8



Source: Eurobank EFG estimates

Source: Federal Reserve, Eurobank EFG estimates

In contrast to the ECB, whose balance sheet expanded modestly and mainly due to liquidity provision, the Fed's quantitative easing represents almost entirely outright asset purchases (Figure 1.7). In particular, purchases of $300bn of treasuries and $1.25tr of MBS and $175bn of agency debt have resulted in an explosion of the Fed's balance sheet to over $2tr from about $900bn right before the Lehman episode, while commercial bank deposits have increased to over a trillion from a meager $11bn in September 2008. As the first step towards exiting is the completion of the MBS and agency debt purchase program, the Fed will first need to face the challenge of how to avoid any adverse effects by markets overreactions when it stops buying securities. The asset purchases were successful in their intended goal of keeping long term interest rates lower than they would otherwise be. However, the winding down of asset purchases may lead to a steeper yield curve beyond what the Fed officials would consider appropriate. To avoid such adverse market reactions, the Fed has adopted a strategy of gradually tapering the size of purchases, so as to allow investors to adapt. Indeed, exit from Treasury purchases has been quite smooth. However, the amount of mortgage backed securities bought is so large compared to the size of the relevant market that tapering may be more complicated to implement and mortgage loan rates as well as long-term rates may increase considerably after the termination of the program. Such an evolution would impair the housing market's modest recovery and cause market turbulence.

The second challenge the Fed is facing is how to effectively increase rates, when appropriate, given its expanded balance sheet. Based on estimates of our Taylor rule model (Figure 1.8), the entire QE program is equivalent to pushing the effective Fed funds rates to nearly 5 percentage points below the level they would otherwise be. Hence, rolling back the Fed's QE program would translate into a sharp increase in effective real short term rates, threatening the rebound of the economy. As a result, we expect the Fed to maintain its expanded balance sheet for a long time and move very gradually towards a normalization of liquidity conditions as the economy recovers and credit markets stabilize.

In our baseline scenario, we expect the Fed to first attempt to drain excess reserves and raise effective Fed funds rates towards the upper end of its target (25bps) by applying reverse repos and paying interest on reserves through a term deposit facility. After gaining some control over excess reserves, the fed will probably start hiking rates by 25bps in September and December and stay on hold for most of the first half of 2011 to assess how markets react, before it embarks on a large-scale tightening.

2. The Euro area economy

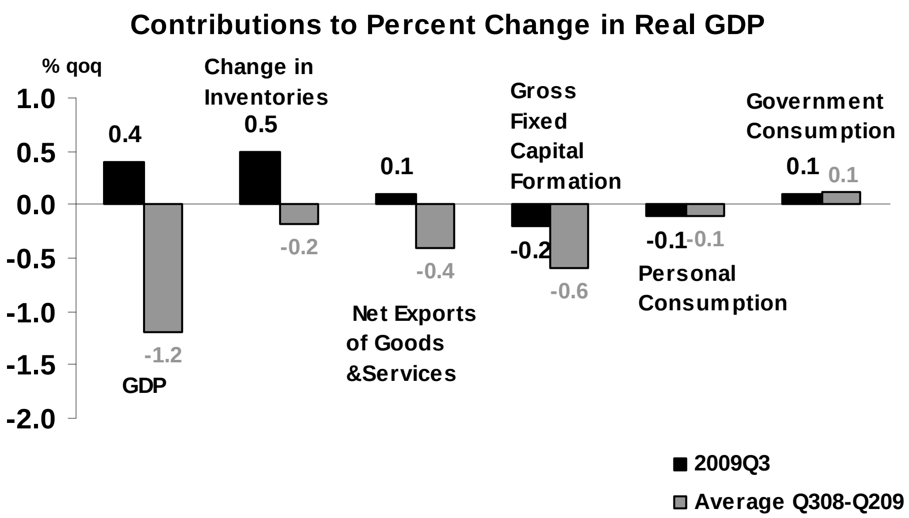
Dimitris Malliaropulos, Olga Kosma

- After an unprecedented downturn since the second quarter of 2008, the Euro area emerged from recession in Q3 09, with net trade and inventories supporting real economic growth.
- Looking forward, we believe that net exports will be the main engine of growth as the recovery in private consumption remains relatively anemic and firms face difficulties in obtaining bank credit to finance investment.
- Euro area exports will probably be the engine of growth, with emerging markets leading the recovery phase.
- We expect the Euro Area recovery to lag behind the US mainly because fiscal consolidation in Ireland and the European South will put a break to economic growth in the Euro area as a whole.
- Although the ECB has already started to unwind some of its unconventional measures, we believe that the exit from the conventional policy measures will depend on the improvement of the macroeconomic conditions. We expect the ECB to keep its key policy rate at current levels until at least H1 2010, before moving towards a tightening of monetary policy at the end of 2010.

The Euro area emerged from recession in Q3 09, with net trade and inventories supporting real economic growth

After a deep downturn having started in the second quarter of 2008, the Euro area economy finally emerged from recession in Q3 09. Real GDP growth increased by 0.4% q-o-q in Q3, after a 0.1% decline in the previous quarter. Net trade and inventories were the main drivers of growth, contributing by 0.1% and 0.5%, respectively, to real economic activity. Inventory liquidation continued in Q3 but at a much lower pace, contributing positively to real quarterly growth. Furthermore, real exports rebounded strongly in the third quarter of the year, increasing by a solid 3.1% q-o-q, after a 4.6% average quarterly decline in the previous year (Q3 08-Q2 09). Imports increased by a lower rate of 3.0% q-o-q, resulting in a positive contribution of net trade (Figure 2.1). Meanwhile, the Eurostat flash estimate for Q4 09 GDP shows that real GDP increased by 0.1% q-o-q, with France growing by 0.6% q-o-q (0.3% q-o-q in Q3 09) and Germany reporting a flat reading (0.7% q-o-q in Q3 09).

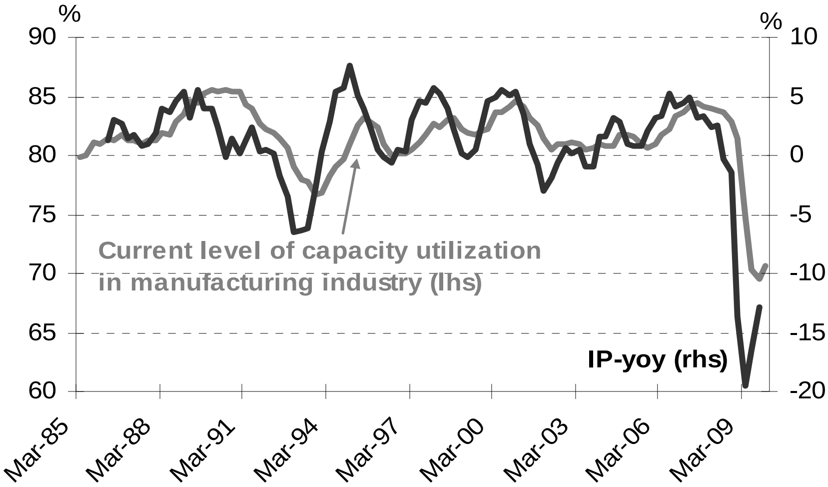
Figure 2.1



Recovery in private consumption to be relatively anemic, compared to the past four Euro recoveries

Final domestic demand was a key negative factor driving GDP downwards, as real private consumption and private fixed investment contracted by 0.1% and 0.8% q-o-q, respectively in Q3 09 (Figure 2.1). The weakness in personal consumption can be largely attributed to the German consumer, where real personal expenditures fell by 0.9% q-o-q in Q3, after a strong bounce in H1 09. The cash-for-clunkers program has run out of steam since the end of the summer and its end is likely to weigh on household consumption for a few quarters ahead. While the breakdown of Q4 09 GDP is not available yet, the hard data suggest that private consumption continued to be rather anemic. Indeed, the drop in retail sales since the second half of 2008 is showing few signs of improvement, as they contracted by 0.2% q-o-q for the seventh consecutive quarter in Q4 09, losing 1.6% on a y-o-y basis. January data suggest that household expenditure will remain relatively weak in Germany, with retailers indicating a further m-o-m reduction in sales. The German retail PMI fell from 47.8 in December to 42.7 in January, reporting its lowest level in twelve months. In addition, Euro area unemployment, which is projected to increase further over the following months and remain relatively high in 2010, will continue to weigh on consumer expenditure, despite the expected rebound in real economic activity. While the pace of job losses in the Euro area has begun to slow and the labour market in Germany continues to surprise on the upside due to the government employment schemes (shorter working hours have successfully shielded the labour market, preventing a bigger rise in the number of unemployed), labour markets in most of the Euro area economies have not adjusted fully to the plunge in real GDP. With real income of households hit by rising unemployment and lower wages, we expect the recovery in private consumption to be relatively weak, compared to the past four Euro recoveries since 1970. Using the OECD database, which includes a time series of aggregate Euro area real GDP and its components, we estimate the average behavior of previous downturns relative to the 2008-09 recession, as well as the average behavior of previous recovery phases since 1970 (Table 2.1). As Table 2.1 shows, real personal consumption accounted for about 1% of the 2.5% average reported growth in the recovery year that followed each Euro area recession. This contribution involves a 1.8% cumulative increase in personal consumption during the four quarters of recovery. However, we believe that the cumulative increase in personal consumption from Q3 2009 that the recovery started to Q2 2010 will not exceed 0.8%, leaving exports the main stimulus for the Euro area recovery in the short term.

Figure 2.2



In line with our historical analysis of business cycle patterns, we do not expect investment to be the steam engine of the current Euro area recovery

Gross fixed capital formation continued to contract in Q3 09, subtracting 0.2% from real GDP growth. Our analysis of the previous four recoveries from recessions suggests that, in contrast to most OECD countries, real investment remains on average flat in the Euro area in the following year of recovery after a recession. Indeed, in both the 1980-81 and 1993-94 recovery episodes, investment continued to decline for 3-5 quarters after each recession, therefore contributing negatively to output growth (Table 2.1). This is not the case for other advanced economies, such as the US and Japan, where gross fixed capital formation starts to increase right away after the end of a recession. During recessions, firms reduce production and operate below capacity levels. As Figure 2.2 shows, investment continues to perform poorly, given record low capacity utilization rates of about 70%. Investment spending usually resumes once the capacity utilization rate reaches around 80%. In order to reach this threshold, industrial production needs to increase significantly and move into positive territory on a y-o-y basis. Until then, we believe that both residential and business investment in the Euro area will probably remain sluggish until at least Q2 10.

Euro area exports will likely be the engine of growth, with emerging markets leading the recovery phase

The Euro area has traditionally had shallow recessions with an average GDP loss of -1.1%, followed by flat recoveries with an average GDP increase of 2.4%. However, the 2008-09 recession, which was a globally synchronized recession, was surprisingly deeper in the Euro area than in the US due to its dependence on international trade. Real net exports have subtracted a total of 1.3% from real GDP growth since Q2 2008, while the average contribution of net trade during the past four Euro area recessions has been slightly positive (Table 2.1). Based on historical standards, net exports have been one of the main drivers of growth in the first four quarters of economic recovery. Consequently, we believe that the considerable improvement in the global economic outlook will feed through to positive net contributions to real GDP growth in the following year for the major euro area economies. Indeed, according to the real GDP data for Q3 09, exports have been one of the main drivers of growth in Germany and France, which reported real GDP growth rate of 0.7% and 0.3% q-o-q, respectively.

Table 2.1: Euro area contributions of expenditure components to real GDP contraction/increase during recession/expansion periods

Contributions to real GDP contraction during each recession

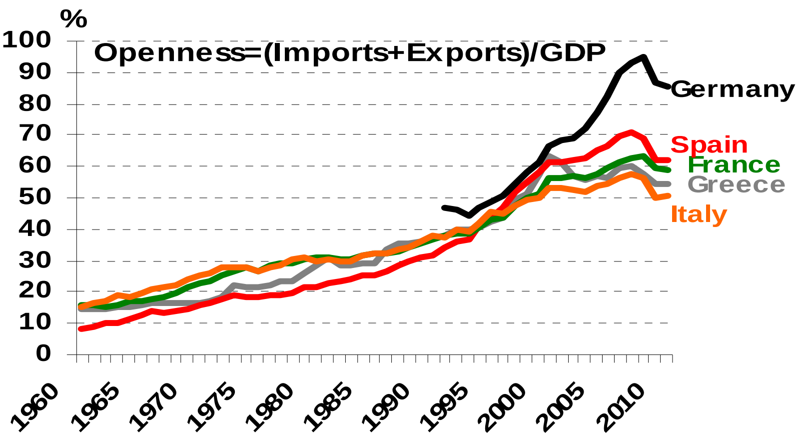
	GDP	CHANGE IN INVENTORIES	GOVERNMENT CONSUMPTION	GROSS FIXED CAPITAL FORMATION	NET EXPORTS	PRIVATE FINAL CONSUMPTION
Q4 74-Q2 75	-1.9	-2.5	0.7	-1.3	0.4	0.7
Q2 80-Q3 80	-0.6	-0.3	0.3	-0.5	-0.3	0.2
Q2 82-Q3 82	-0.4	0.1	0.1	-0.3	-0.1	-0.2
Q2 92-Q1 93	-1.6	-0.9	0.3	-1.5	1.0	-0.5
average	-1.1	-0.9	0.4	-0.9	0.3	0.0
Q2 08-Q2 09	-5.2	-0.9	0.6	-2.7	-1.4	-0.8

Contributions to real GDP increase over a year after each recession

	GDP	CHANGE IN INVENTORIES	GOVERNMENT CONSUMPTION	GROSS FIXED CAPITAL FORMATION	NET EXPORTS	PRIVATE FINAL CONSUMPTION
Q3 75-Q2 76	5.0	1.2	0.7	0.7	-0.5	2.9
Q4 80-Q3 81	1.0	-1.3	0.7	-0.6	2.0	0.1
Q4 82-Q3 83	1.8	0.0	0.4	0.1	0.7	0.6
Q2 93-Q1 94	1.6	0.2	0.2	-0.3	0.7	0.8
average	2.4	0.0	0.5	0.0	0.7	1.1

Source: OECD database, Ecowin, Eurostat, EFG estimates

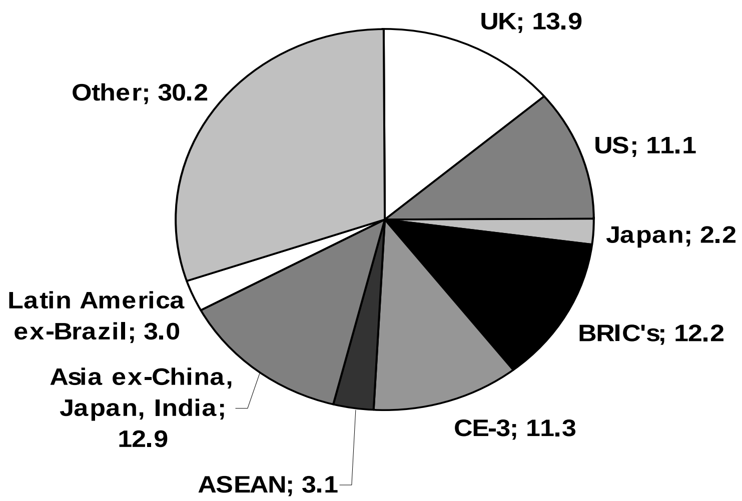
Figure 2.3



As Figure 2.3 depicts, the trade openness of the Euro area has actually increased rather markedly through time, especially since the early 1990s. An important characteristic of the Euro area for understanding the area-wide impact of external shocks is the highly-differentiated degree of openness among individual member states, both with regard to their total trade as well as their internal trade within the Euro area. Germany shows the highest degree of openness, with its imports and exports ratio to GDP currently standing at 87% from 44% in 1993, while other countries tend to be more closed than Germany, with a total degree of openness (including intra euro-area trade) in the range of 50-60%. As a result, the collapse of global demand in 2008 has hit open economies such as Germany the most, reporting a cumulative decline of 6.8% from Q2 08 to Q1 09.

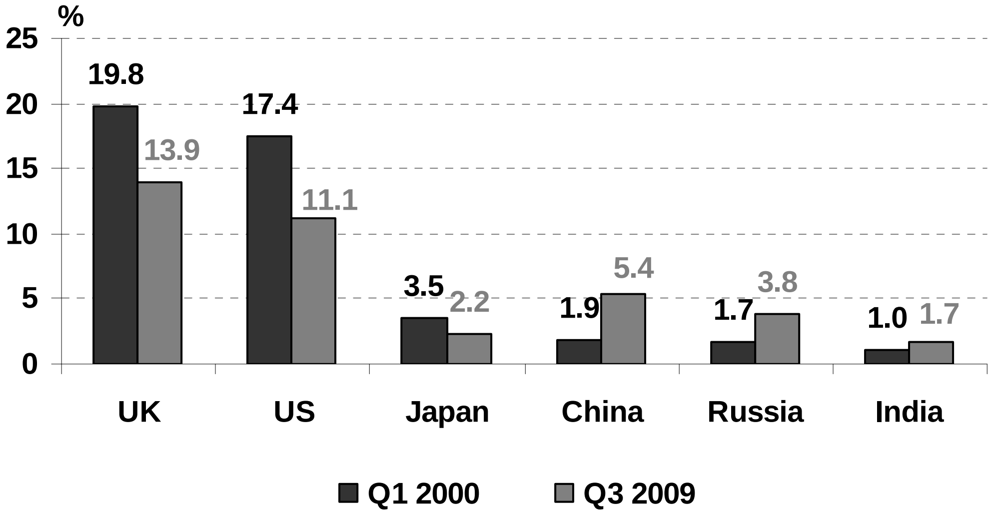
Over the past three months, Euro area exports have begun to stabilize from their headlong fall since the onset of the recession. The resurgence in activity in emerging economies, especially in China and India, is expected to play a significant role in the Euro area's export growth. Although the largest export partners for Euro area products are the UK and the US, which together account for 25% of Euro area export goods (Figure 2.4), BRIC's have doubled their share in Euro area exports since 2000. In particular, China has almost tripled its export share, from 1.9% in Q1 2000 to 5.4% in Q3 2009 (Figure 2.5). While the Euro area export performance in August disappointed to most major destinations, exports to China and India have increased significantly since January 2009 due to a robust recovery in their domestic demand (Figure 2.6). In contrast to advanced economies, whose weights in Euro area exports has gradually declines through time (Figure 2.5), we believe that the BRIC's share as an export destination of Euro area exports will continue to rise, helping European exports to be the engine of growth again.

Figure 2.4
Euro area's main export partners (as of Q3 09)



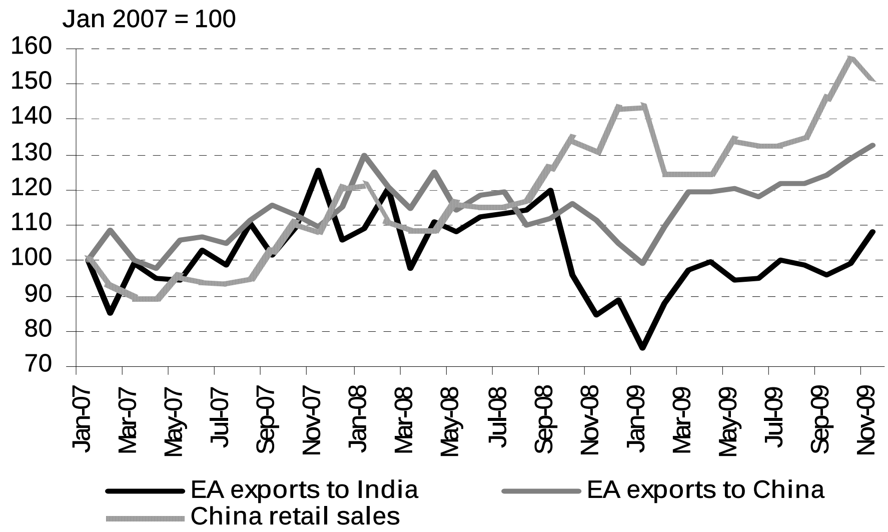
Source: Eurostat, Ecowin, EFG estimates

Figure 2.5
Rising share of Euro area's exports to emerging economies



Source: Eurostat, Ecowin, EFG estimates

Figure 2.6
Exports to China & India are surging



The Euro Area recovery is likely to lag behind the US

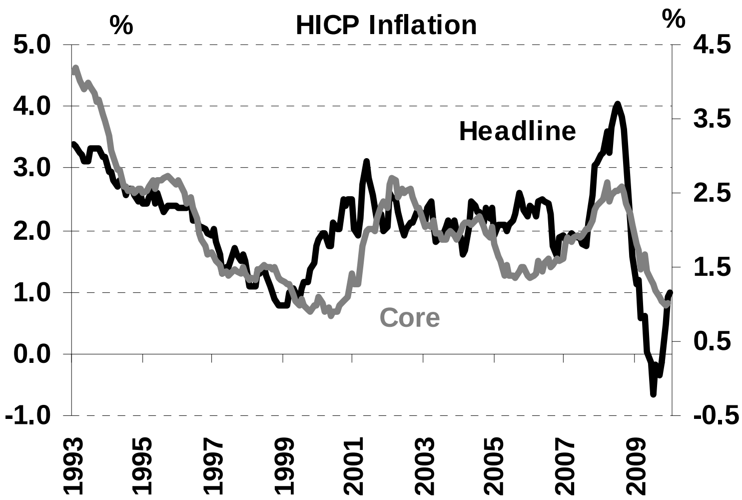
However, we expect the Euro Area recovery to lag behind the US for three reasons: 1) European companies are more dependent on bank credit to finance investment activity. Hence, the process of de-leveraging of the banking sector will put constraints on credit availability and, consequently, undermine future prospects for private investment and consumption. 2) Contrary to the US, where the fiscal stimulus will continue to support growth (President Obama unveiled a new budget plan for 2011), fiscal policy is likely to be more restrictive in the Euro area. The underlying problems in countries such as Greece, Spain, Portugal, Ireland (they comprise about 16% of EA's GDP) would entail significant fiscal tightening, impeding the revival of growth prospects in the Euro area as a whole. 3) In the US, earnings growth is supported by a widening of corporate profit margins as companies continue to cut costs. The main driving force behind this cost-cutting process is in our view the decline in unit labor costs, a consequence of the significant increase in unemployment during this recession. As a result, the large degree of flexibility of the labor market in the US will give (even temporarily) an upside boost to economic growth. On the contrary, in the Euro area, the reaction of businesses to the economic downturn was not as strong compared to the US. Therefore, there was no significant increase in productivity and, consequently, there was a less significant decline in unit labor costs, delaying the recovery process.

Headline consumer inflation turns positive, while core inflation continues its downward trend

Headline HICP inflation went into negative territory in June 2009, hitting its lowest level since the onset of the series in July 2009 (-0.7% y-o-y). As we have projected in our Global October edition, the fading base effects and a renewed increase in energy prices have driven headline inflation gradually higher over the last few months (Figure 2.7). As a result, the headline inflation turned positive for the first time in November, with the y-o-y growth increasing to +1.0% in January. Meanwhile, EC's measure of consumer price expectations over the next 12 months, which hit rock bottom in August 2009, has slowed significantly its downward trajectory since September. We expect the annual headline inflation rate to rise to 1.5% in 2010 from an average of 0.3% in 2009.

However, core inflation is expected to continue its downward pattern into 2010, driven by persistent excess capacity and rising unemployment (Figure 2.7). Although unit labour cost growth has risen sharply since the beginning of the recession due to the decline in productivity and the anemic reaction of wages to the drop in output, unit labor costs are expected to decline in 2010, as productivity recovers with the cyclical improvement in activity. Given the expected trend of ULCs in the Euro area, core inflation will probably moderate into the following year.

Figure 2.7



Unwinding the unconventional policy measures

The ECB on its December meeting offered some insight into the exit strategy from its unconventional policy measures. As we had expected, the Central Bank seemed prepared to withdraw from its non-standard operations, based on improved financial conditions which call off the usefulness of some of its liquidity measures. The major changes announced were the following:

- The 12m longer-term refinancing operation (LTRO) allotted on December 16 will be the last of its kind. The interest rate in the final 12m refinancing operation will be fixed at the average minimum bid rate of the weekly main refinancing operations (MROs) during the lifetime of this operation.
- The 6m LTRO will end March 31, 2010. This operation, as well as the regular 3m LTROs scheduled for Q1 10, will be carried out with a full allotment fixed rate tender procedure.
- The special 1m refinancing operations will continue to be conducted with full allotment for at least the first three maintenance periods of Q1 10.
- The weekly MROs will continue for as long as is needed, at least until the third maintenance period of 2010 ends on 13 April.

Although the ECB has already started to unwind some of its unconventional measures, we believe that the exit from the conventional policy measures will depend on the improvement of the macroeconomic conditions. The ECB will first ensure that the Euro area recovery is convincingly established, before beginning rate normalization. Therefore, we expect the ECB to keep its key policy rate at current levels until at least September, and then move gradually at the end of 2010 towards a tightening of monetary policy.

EFG Macro Model Forecasts: Euro area economy

	Actual	------------- Forecasts ---------------						
	2009:Q4	2010:Q1	2010:Q2	2010:Q3	2010:Q4	2009	2010f	2011f
GDP y-o-y	-2.1	1.0	1.6	1.5	1.4	-4.0	1.4	2.0
Consumption y-o-y	-0.3*	0.0	0.3	0.4	0.5	-0.9*	0.3	1.2
Labor Market								
Employment y-o-y	-2.2*	-1.7	-1.3	-1.1	-0.8	-1.8*	-1.2	0.3
Unemployment Rate	9.9	10.3	10.4	10.6	10.6	9.4	10.5	10.4
Inflation								
Headline CPI y-o-y	0.4	1.2	1.3	1.5	1.8	0.3	1.5	1.6
Core CPI y-o-y	1.1	0.9	0.8	0.8	0.8	1.4	0.8	1.0

Note: All forecasts are based on the estimates of a quarterly econometric model of the Euro area economy.
* Forecasts

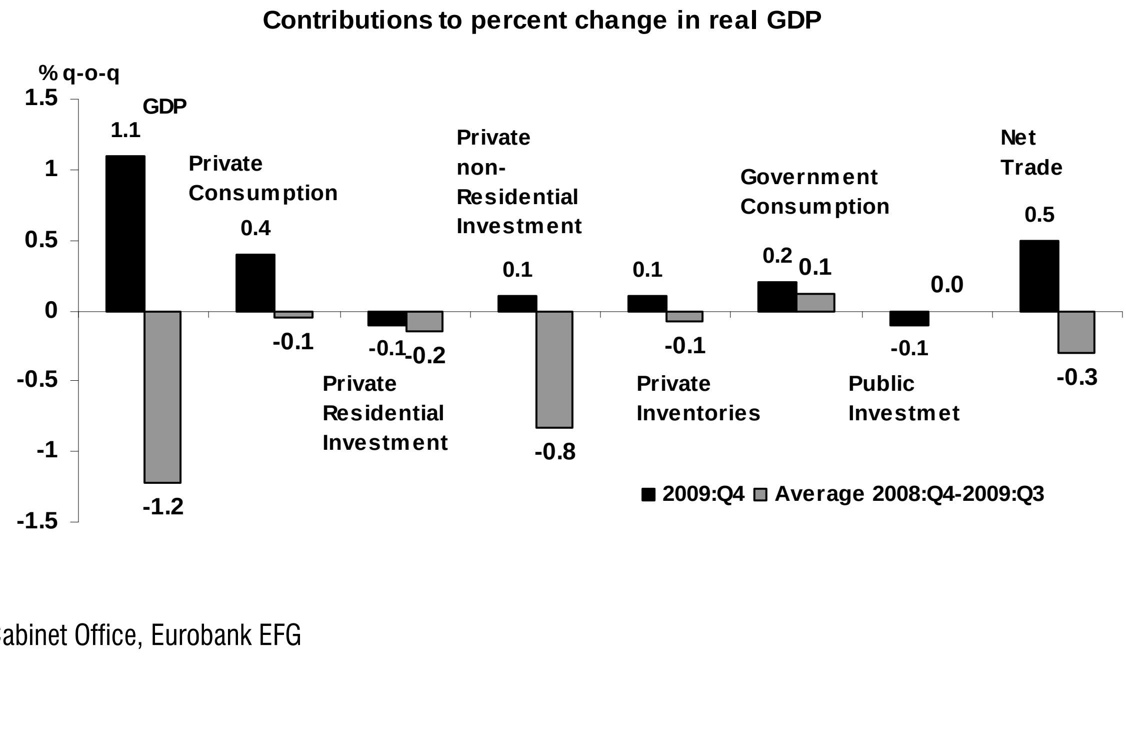
3. The Japanese economy

Dimitris Malliaropulos, Vasilis Zarkos

- The Japanese economy grew by 4.6% annualized in Q4 2009. Exports due to growing global demand and inventory rebuilding played a key role in dragging the economy out of recession. The inventory rebuilding overseas is expected to continue boosting the economy in Q1 2010
- Upside risks for exports are improvements in global trade and yen depreciation due to increasing global risk appetite and supper accommodative monetary policy. A downside risk factor stems form monetary tightening in China.
- Given that weak domestic demand deprives the economy of autonomous drivers and the inventories impact will eventually fade out, the economy is expected to grow modestly in H2 2010.
- Weak domestic demand has led to an uneven recovery as non manufacturing firms haven't benefited much from exports. Persistent unemployment poses a downside risk on consumer spending.
- Deflationary pressures persist as demand remains week and labor costs low. Given the economic weaknesses, the Bank of Japan will maintain its accommodative policy. Interest rate hikes are not expected before at least H2 2011.

The Japanese output expanded by 4.6% annual rate (first preliminary posting) in the last quarter of 2009 after GDP growth was revised down to zero in Q3, due to a negative contribution of domestic demand. Japan's exports played a key role in pulling the country out of recession (Figure 3.1). As consumption in the developed world is picking up, firms need to rebuild their inventories, while manufacturers in developing countries are increasing capital expenditures to meet global demand. Both developments are boosting Japanese exports which grew by 21.7% ar in the fourth quarter. The inventory rebuilding overseas is expected to continue boosting the economy in H1 2010, whereas its impact will probably fade out in H2. This development along with week domestic demand due to high unemployment will constrain GDP growth later in 2010 to a moderate level.

Figure 3.1

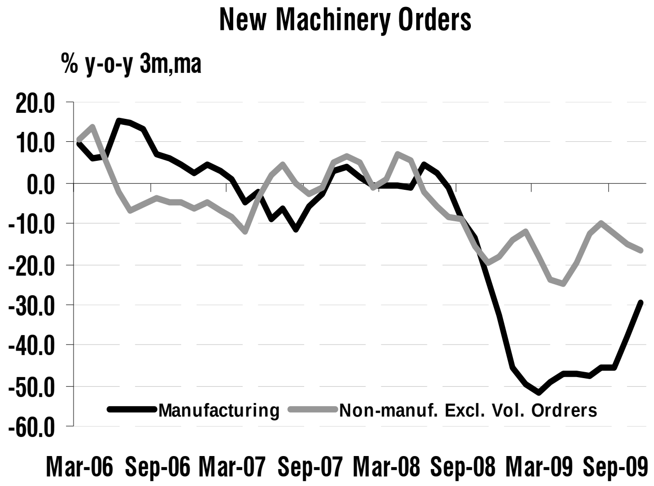


Source: Cabinet Office, Eurobank EFG

New machinery orders (Figure 3.2) rose by 7.8% q-o-q in Q4. Orders from overseas rose by 28.4% last quarter following a 41.7% in Q3, indicating the large impact that the global recovery is having on Japanese industry. Meanwhile, the industrial production index (Figure 3.3) is on an upward trend since its trough in February, reading 89.9 in December. The improvement of the PMI Index since July is in line with the positive trend in industrial production. On the grounds of increased manufacturing activity we believe that domestic and foreign capital expenditures will support the economic rebound in Japan. According to the Tankan survey released in December, the business conditions DI (all enterprises) rose from -41 in Q3 to -34 in Q4 while its projection for the first quarter of 2010 is positive. Indices related to domestic and overseas supply and demand for products of all Japanese industries have also increased on a quarterly basis while their forecast for Q1 2010 exhibits further improvement. However, signs of the fading impact of the inventories rebuilding have emerged as the PMI Manufacturing Index receded to 52.5 in January from 53.8 in December, while machinery orders from oversees are forecasted to decline by -15% in Q1 2010.

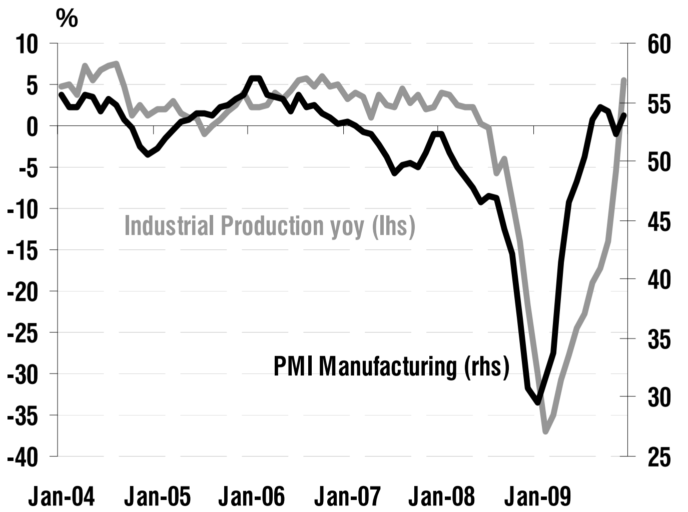
Exports (Figure 3.4) are currently impaired by the appreciation of the yen relative to major currencies. However, we expect that the yen will depreciate for the following reasons. First, as global risk appetite is increasing, appreciation pressures due to carry trade will abate. Moreover, the Bank of Japan is bound to continue its quantitative easing, as opposed to the Fed which is expected to raise rates in the second half of 2010. The above developments along with improving global trade pose an upside risk on Japanese exports. Using the consensus view of 5% depreciation by the end of 2010, we estimate a y-o-y increase in exports of about 11%. However, given the large share of exports to China, monetary tightening in China poses a downside risk on Japanese exports.

Figure 3.2



Source: Cabinet Office, Ecowin

Figure 3.3



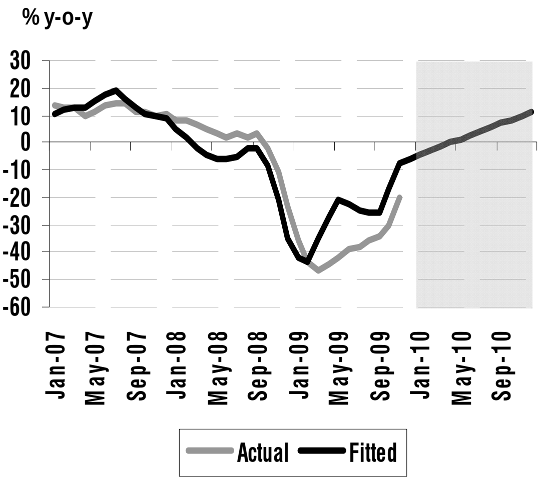
Source: Ecowin, Bloomberg

Low domestic demand is a structural hurdle which deprives the Japanese economy form autonomous drivers and threatens its economic recovery. Japan’s economy is heavily depended on exports as personal expenditures have traditionally been low. The dependence on exports renders the Japanese economy rather vulnerable to adverse global developments as consumers cannot make up a loss form falling exports (Figure 3.5). Private consumption accounts for roughly 55% of Japanese GDP whereas the respective percentage in the US is about 70%. Thus, a great deal of the recovery in Japan lies on how large the global rebound will be.

A restrained domestic demand seems to have led to an uneven recovery of the industrial sector as only large manufacturers have benefited from the export led rebound. A more careful analysis of the Tankan survey reveals negative developments for small enterprises and non manufacturing firms over the first quarter of 2010. In addition, non manufacturing machinery orders (excluding volatile orders) have been quite volatile, as opposed to the sharp rebound of the orders in the manufacturing sector (figure 3.2). The observed differences in sentiment, do not come as a surprise as small firms and the non manufacturing sector are more dependent on domestic consumption rather than on global trade. Figures about retail sales have been disappointing as they are still on negative territory on a y-o-y basis, although the decline is narrowing.

Figure 3.4

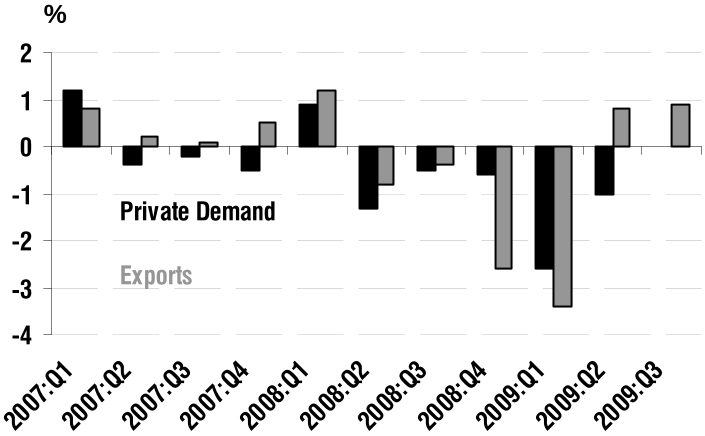
Exports Growth Forecast



Source: Ecowin, Eurobank EFG estimates

Figure 3.5

Contribution of Private Demand and Exports to GDP



Source: Cabinet Office

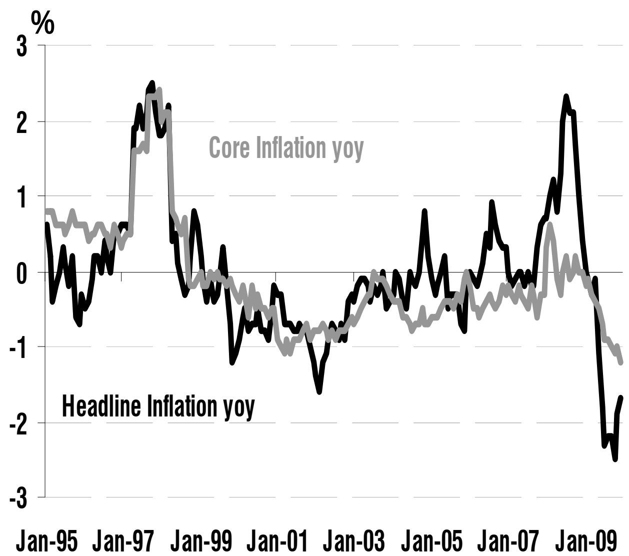
Persistent high unemployment and low wages (Figure 3.6) contain expenditures and pose a downside risk on the economic rebound. Unemployment receded to 5.1% in December after inching higher by 0.1% to 5.2% in November. Firms continue to perceive employment conditions as excessive, while wages remain low as they lag improvements in industrial production. The jobs-to-applicants ratio inched to 0.46 in December from its trough in July (0.42). The ratio is still very low and many new jobs are temporary. However, we expect employment to benefit from improving industrial activity later in the year. The Economy Watch Survey points to better future conditions for households as the related index increased to 35.5 in December after a slow down in October and November (42.4 and 34.1 respectively from 44.1 in September).

Recovery conditions are deteriorated by strong deflationary pressures (figure 3.7). Japan is officially in deflation since November. National core CPI fall is accelerating since January 2009 (-0.2% y-o-y), reaching -1.2% in December. Risks for deflation remain on the downside as long as domestic demand remains subdued. The Tankan survey shows deteriorating sentiment as regards to corporate trade due to declining selling prices affecting the entire business spectrum. Deflation takes a heavier toll on the non-manufacturing sector, whose rebound is consumer spending driven rather than exports driven.

Figure 3.6

Source: Ecowin, Bloomberg

Figure 3.7



Source: Bloomberg

Deflationary pressures have caused real interest rates to rise and, in turn, credit conditions to remain tight. The Bank of Japan has kept its interest rate at 0.1% and launched a new liquidity facility of around JPY10tn in three month loans at fixed rate in an attempt to encourage a further decline in longer-term interest rates. Given the headwinds against the Japanese economy, we anticipate that the Bank of Japan will expand its balance sheet in 2010 in an attempt to depreciate the yen. A target rate hike seems highly unlikely before H2 2011.

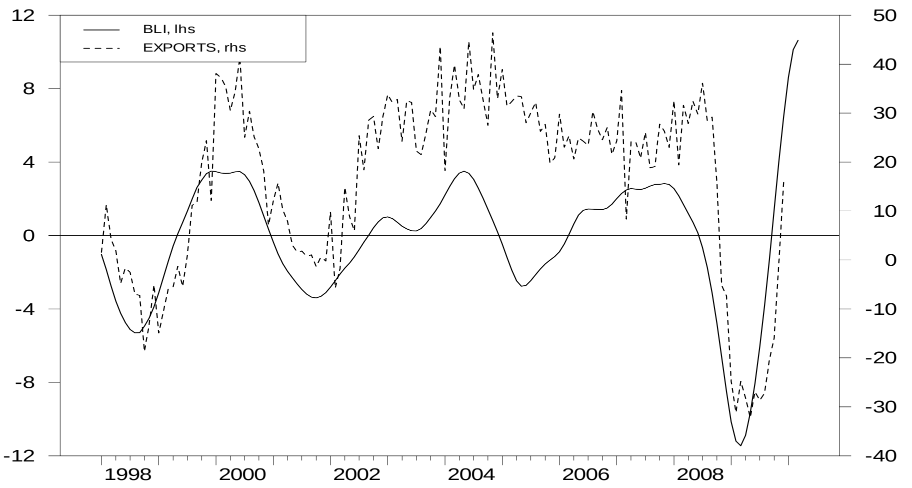
4. Emerging Markets

Dimitris Malliaropulos, Maria Prandeka

- Most of the rebound in global growth is expected to continue to be fueled by emerging economies, where domestic demand remains resilient and export demand improves significantly.
- A sustained recovery in Emerging Asia, which bounced back from the global downturn much more strongly than any others, now seems more possible, given the revival in private domestic demand and improving labor markets.
- Most economies in Emerging Europe have returned to positive growth rates, albeit the region continues to lag behind emerging Asia and Latin America in their recoveries.
- Growth in Latin America will continue to be supported by rising commodity prices, though much will depend on Asian imports of commodities.

Emerging Markets (EM) economies have weathered the global economic crisis well and now they are leading global growth. This mainly reflects stronger fundamentals, such as a less leveraged private sector and better external balances. In most parts of the emerging world domestic demand has proved particularly resilient during the crisis, labor market conditions are improving and exports have bounced back, while they are set to improve further. Indeed, our BRICs leading indicator, which has moved out of negative territory in H2 2009, points to stronger exports ahead (Figure 4.1). As a result, we believe that most of the rebound in global growth will continue to be fueled by emerging economies. Nevertheless, the major challenge to the EMs' upbeat growth outlook is inflationary pressures, stemming mainly from rising commodity prices and the rebound in capital inflows, owing to a resurgence in risk appetite. Thus, policymakers in EM's economies is likely to be forced to withdraw stimulus and tighten monetary policy earlier than advanced economies, weighing on the nascent recovery in domestic activity. Indeed, central banks of major emerging economies (such as China and India) have already embarked on a tightening path, as pressures on consumer price inflation have intensified in these countries. As a result of inflationary pressures, we might see currency appreciation in EMs, particularly in countries such as China where exports have rebounded strongly, as it would help contain inflation and manage capital inflows.

Figure 4.1
BRICs Leading Indicator*, % yoy



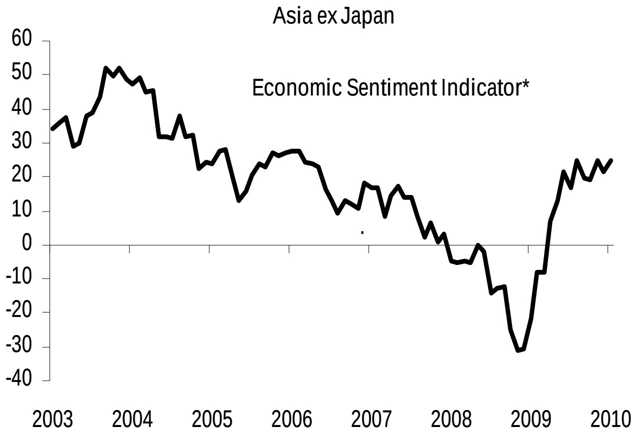
* 3 month forward, Source: Eurobank EFG

As far as single regions are concerned, Emerging Asia is leading the recovery, due to aggressive monetary and fiscal policy easing. The sharp bounce back in Asia has helped Latin America to register significant signs of improvement, due to increased trade linkages with Asia. Elsewhere, although Emerging Europe continues to lag behind the rest of the emerging world, there are some bright spots in the region, with the stress in the banking sector easing.

Emerging Asia

Emerging Asian economies bounced back from the global downturn much more strongly than any others. This is in large part due to significant monetary and fiscal policy responses and better external balances. Indeed, the big share of infrastructure investment in the fiscal stimulus packages will underpin long-term growth prospects, as its effect is spread over several years. Leading indicators suggest improving economic activity across the region, with the Asia ex Japan economic sentiment indicator being on an upward trend over the past year (Figure 4.2, left). Indeed, real GDP growth rebounded strongly across the region in Q4 09, with the most pronounced evidence of recovery witnessed in China, where real GDP growth accelerated to 10.7% y-o-y from 9.1% y-o-y in Q3 09. Industrial production is back at pre-crisis levels, underpinned by a strong rebound in global trade. Exports of goods and services rebounded strongly since their trough levels in the beginning of 2009 and they do not show any sign of a slowdown yet. Meanwhile, in China, the PMI new export orders index rose for the ninth consecutive month above the threshold of 50 in January (to 53.2), suggesting that the pace of exports revival should gain further momentum in the coming months. Indeed, the US ISM new orders index, which has increased significantly from its trough level in December 2008, reinforces this view (Figure 4.2, right). Industrial and trade activity will continue to be strongly supported by inventories restocking in Q1 10. Moreover, companies across the region have started investing again, given that the worst case scenario, for which they were preparing in the beginning of 2009, has not materialised. Therefore, a sustained recovery in the region now seems more likely, given the revival in private domestic demand and improving labor markets. Nevertheless, the major challenge to the region’s upbeat growth outlook is an earlier than anticipated monetary policy tightening, as inflationary pressures have already started to mount, owing to rising food and commodity prices. Indeed, in India WPI inflation (ex food) climbed to 7.3% y-o-y in December, forcing the Reserve Bank of India to follow China in tightening policy. The latter has raised recently the reserve requirement ratio by a total of 100 bps to restrain the economy from overheating, as loan growth accelerated sharply and inflation is surging.

Figure 4.2



Source:Ecowin

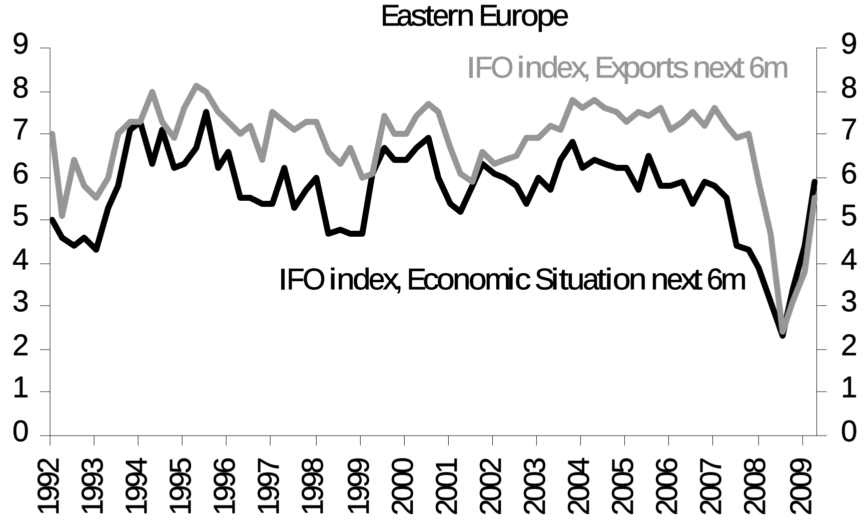
Source:Ecowin

*The sentix sentiment indicator is a monthly survey among financial analysts and institutional investors about the expected economic situation.

Emerging Europe

Most economies in Emerging Europe have returned to positive growth, albeit the region continues to lag behind emerging Asia and Latin America in the recovery. We expect the outlook for the region to gradually improve as euro area -its main trading partner- recovers. Indeed, in Q4 09, both the Eastern Europe IFO economic situation index and the index for export volumes over the next six months rose above the 5-point-level that indicates expansion for the first time since Q3 08 (Figure 4.3). Manufacturing PMI indices across the region improved further in recent months, boosted mainly by an inventory rebound, and this has already shown in industrial production numbers. In Russia, for example, PMI passed the threshold of 50, which indicates expansion, in January, while industrial production expanded for the second consecutive month in December by 2.7% y-o-y, suggesting that the recovery is gathering pace. In our view, the recovery in Emerging Europe will be mainly export driven, while domestic demand will lag behind for several factors. To begin with, in some countries labor market conditions continue to be under stress, intensifying downside risks for consumer spending. Russian unemployment remains elevated, adding to the pressures faced by some economies in the region that are heavily dependent on Russia for remittances. Furthermore, the fragile banking sector along with the prevalence of foreign exchange denominated lending, that increases the risk of a further rise in non-performing loans, are likely to continue to constrain bank credit. Meanwhile, sizeable deterioration in public finances, due to massive fiscal stimulus, suggests that there is little scope for further fiscal easing, impeding the recovery in the region. As far as inflation is concerned, it has risen in recent months across the region, mainly due to low base effects from the collapse of oil prices. However, inflation prospects for the region are favorable, owing to excess spare capacity, currency strength and low wage growth.

Figure 4.3



Source: Ecowin

Latin America

Recent economic indicators suggest that a solid recovery in the region is well underway, underpinned by effective fiscal and monetary measures and improved policy frameworks that contained the worsening of domestic demand. Indeed, the Latin America IFO economic expectations index has increased further in Q4 09 from its trough in Q1 09, suggesting that the region is already in the upswing phase of the business cycle (Figure 4.4, left). This is largely supported by the recent strong recovery of Asian economies, particularly China, a key destination of LA's exports. In line with the positive outlook for the region's export growth, that has been a key factor driving the recent improved growth performance, the Latin America IFO index for export volumes over the next six months has increased further in Q3 09 (Figure 4.4, right). The benign outlook for China's economy, that created favourable prospects for commodities, contributed positively to LA's recovery. However, given the region's sensitivity to the commodity cycle and that China's demand for commodities has already started to slow over the past few months, a major challenge for the region is that a sustained reduction in Chinese imports of commodities may weigh on their prices and, consequently, on LA's outlook. Another key issue for the region will be widening current account deficits, as import growth is likely to outpace that of exports, mainly because domestic demand is expected to prove stronger than external demand. Nevertheless, strong capital inflows, due to increasing risk appetite, will finance the deficits, deterring balance of payments risks.

Figure 4.4

Source: Ecowin

Source: Eurobank EFG, Ecowin

* Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Venezuela

4.1 China Economic Outlook

The combined fiscal and monetary policy actions coupled with the unprecedented domestic credit expansion have effectively helped the economy not only to avoid a sharp economic downturn in 2009, but also to stage a robust recovery, with economic growth surprising significantly on the upside. However, the aggressive policy responses bear significant risks for 2010, including inflationary pressures and the emergence of asset price bubbles. Against this backdrop, policymakers could be forced to tighten policy sharply, derailing the recovery and exacerbating volatility in the main drivers of economic growth.

Real GDP grew by 8.7% y-o-y in 2009, compared with 9.6% in 2008, on the back of strong domestic demand, which contributed 12.6 percentage points to GDP growth, offsetting the negative contribution of net exports of 3.9%. Fixed asset investment (FAI) continued to be the largest source of domestic demand growth, driving real GDP up by a total of 8%. The surge in FAI growth was driven by significant public investment (accounting for about 30% of total FAI) and credit expansion. Meanwhile, in the past few months real estate investment –the key driver of private investment growth- has picked up strongly, boosted by a buoyant property market. In December, home prices in 70 major cities rebounded to a 19-month high of 7.8% y-o-y. Should property investment maintain this robust momentum in 2010, the negative impact to FAI growth from the expected slowdown in public investment will be offset. As a result, the drivers of economic growth are likely to become more balanced this year, with investment shifting from government-led towards private-led.

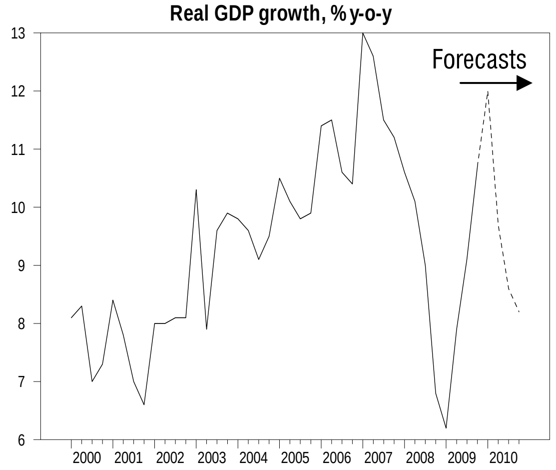
In line with robust growth momentum, industrial production growth surged to 12.5% y-o-y in 2009, slightly below the 12.7% reading in 2008. China's NBS PMI manufacturing index picked up to 56.6 for the fourteenth consecutive month in December, with all sub indices also suggesting broad-based revival of activity. The employment sub index suggests benign labor market conditions.

Table 4.1
China Main Economic Indicators and Forecasts

	2008	2009	2010e	2011e
Real GDP (% y-o-y)	9.6	8.7	9.6	9.0
IP** (avg, % y-o-y)	12.7	12.5	15.0	12.0
Inflation (avg, % y-o-y)	5.9	-0.7	3.0	3.5
Unemployment rate (avg, %)	4.2	4.3	4.2	4.2
External Balance				
Real Exports of G & S* (% y-o-y)	10.0	-11.0	14.0	12.0
Real Imports of G & S* (% y-o-y)	8.0	-9.0	15.0	13.0
Trade Balance (% GDP)	6.0	4.4	3.5	3.5
Current Account (% GDP)	9.5	6.3	5.5	5.0
Interest Rates	Dec 09	Current	Dec 10	Dec 11
Lending Interest Rate (%)	5.31	5.31	5.85	6.40
Exchange Rates	Dec 09	Current	Dec 10	Dec 11
USD/RMB, eop	6.8	6.8	6.5	6.3

*Goods & Services, **Industrial Production, Source: Eurobank EFG estimates

Figure 4.5



The latter alongside an improving housing market, rising consumer confidence and increased policy support aiming at promoting consumption will support private consumption growth, the contribution of which to growth is expected to rise in 2010, from 4.6% in 2009. On the external demand front, following a sharp contraction in 2009, net exports are expected to contribute positively to real GDP growth in 2010, in line with strong global recovery.

Inflation: the main risk to China's upbeat growth outlook

However, robust exports will add to inflationary pressures that already constitute a significant risk to China's outlook. Indeed, both consumer and producer price indices returned to inflation in November and December respectively, rising sharply from negative rates. Surging food prices, which accounts for about a third of the consumer basket in China, is the main factor driving inflation upwards. Moreover, given that China's inflation is highly correlated with the commodity cycle, an upside surprise to commodity prices as the global economy recovers strongly, will likely result in stronger inflationary pressures. Asset price inflation is another reason raising the risk of inflation in 2010, as property prices increased rapidly in 2009, on the back of ample credit availability. Money supply growth has accelerated from an average of 16.7% y-o-y in 2008 to an average of 26.5% y-o-y in 2009. In particular, Chinese banks have increased new lending by RMB9.6 trillion (28.6% 0f GDP) in 2009 (almost double that of 2008), with the y-o-y increase in loans jumping to 30.9% in 2009 from 15% in 2008 (Figure 4.6, left). Meanwhile, in the first two weeks of January, new lending reached 1 trillion, compared with a target of CNY7.5 trillion for the whole year. Should this rate of credit expansion be maintained in the coming months, inflationary pressures will intensify. However, we should not disregard the fact that banks might have brought forward new loans, as a result of the oncoming monetary tightening. We expect the annual headline inflation rate to rise to 3.0% in 2010 from an average of -0.7% in 2009.

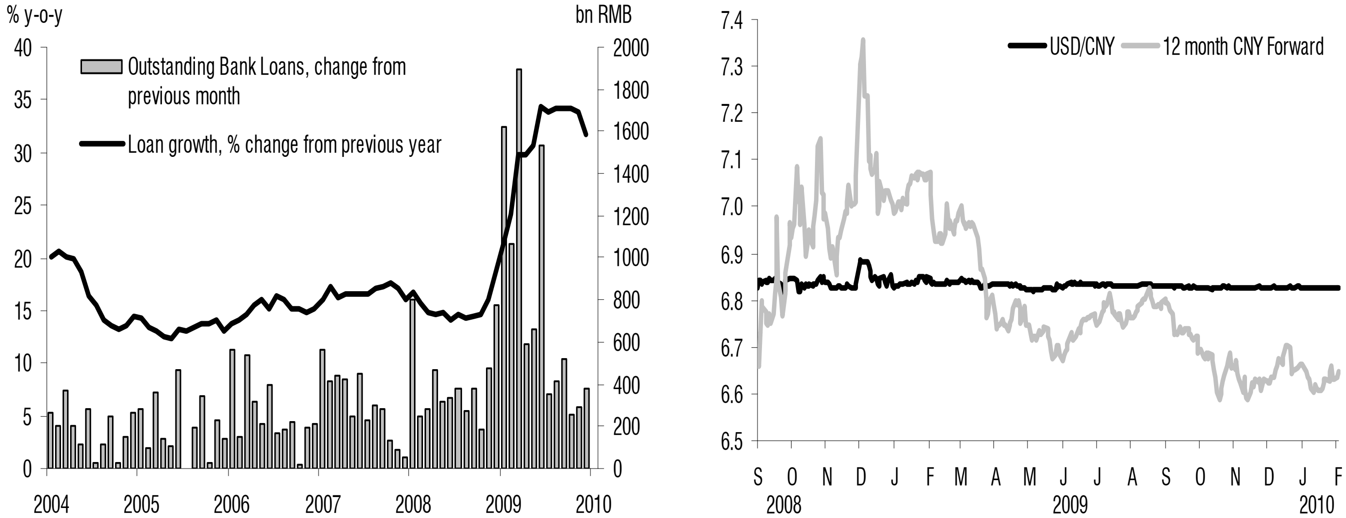
Inflationary pressures along with increasing signs of overheating of China's economy force the central bank to tighten monetary policy…

Against this inflationary environment, policymakers could be forced to tighten policy sharply and earlier than expected, derailing the recovery and exacerbating volatility in the main drivers of economic growth. Indeed, the PBoC raised the reserve requirement ratio (RRR) by 100 basis points over the past month. It is likely that this move mainly reflects the central bank's intention to curb lending and manage interbank liquidity. As a result, we believe that policymakers will proceed with further RRR hikes and open market operations, before they raise benchmark interest rates in H2 2010. Particularly, in our view, the first interest rate hike will partly depend on that of the US Fed, due to the Rmb's peg to the US dollar. Indeed, if the PBoC were to raise interest rates ahead of the Fed, it would encourage more capital inflows, adding to inflationary pressures.

…and intensify renminbi's appreciation

As inflationary pressures build up in headline indices, currency appreciation becomes a more likely scenario. Moreover, international political pressure for China's currency appreciation is intensifying, as Chinese exports growth continues to outpace most major economies. Particularly, increased pressures are stemming from the US, in order to narrow its trade deficit with China. Indeed, the 12 month RMB NDF forward implies rising expectations of CNY appreciation by year end (Figure 4.6, right). However, it is unlikely that policymakers would allow a large and one-off appreciation, as this move will entail risks for the real economy. In our view, a gradual appreciation of the CNY versus the USD is the most likely scenario. We envisage an appreciation of around 5% until end-2010.

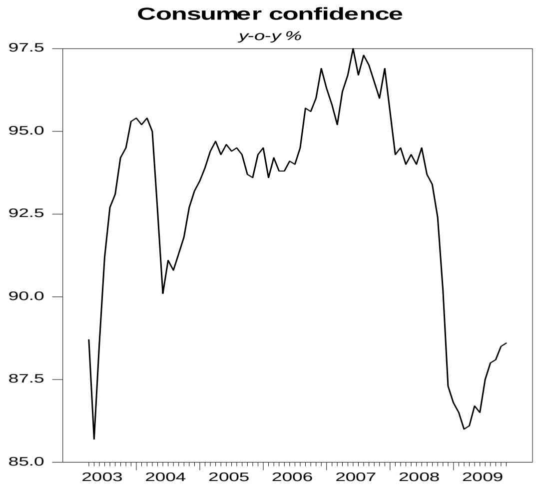
Figure 4.6

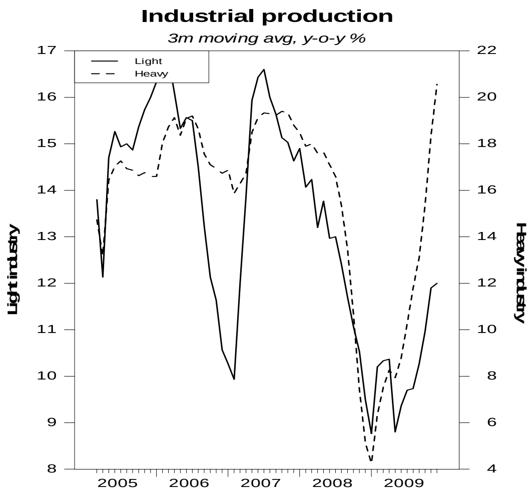


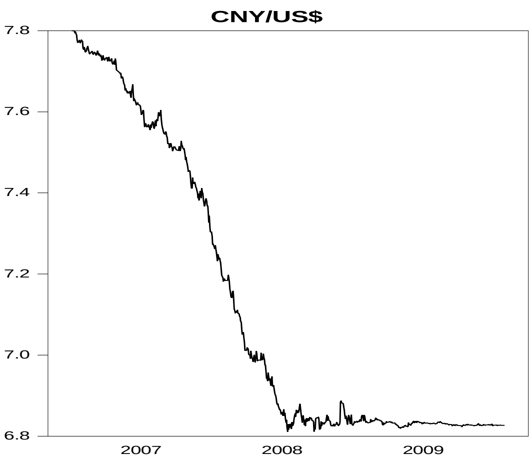
Source: Ecowin

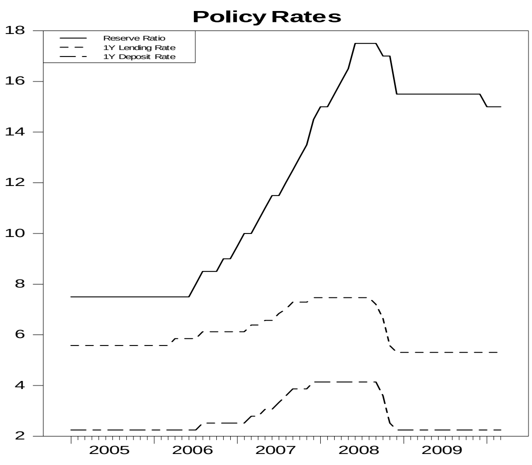
Source: Bloomberg

CHINA CHARTS









Source: Bloomberg, Ecowin

4.2 India Economic Outlook

India is one of the first emerging market economies that emerged from the global downturn. Proactive fiscal and monetary measures, combined with a resurgence in capital inflows and reviving domestic demand have brought growth close to pre-crisis levels. Looking forward, India's economy is expected to gather further momentum, underpinned mainly by domestic demand. However, rising inflation and a high fiscal deficit are key risks to India's upbeat growth outlook.

India's economy grew by 7.9% y-o-y in Q3 09, following a 6.1% y-o-y growth in Q2 09. Strong government spending (26.9% y-o-y) continued to prop up domestic demand, while lagged effects of fiscal and monetary policy easing gave a great boost in manufacturing activity, which jumped to 9.2% y-o-y in Q3 09 from 3.4% y-o-y in Q2 09. Recent economic indicators confirm that domestic demand is bouncing back strongly. Industrial production increased by 11.7% y-o-y in November 09, after a 2.2% y-o-y growth in H1 09. The rebound was led by all three segments of the industrial sector; manufacturing, mining and electricity. Output of consumer durable goods recorded a marked growth of 37.4% y-o-y, reflecting rising consumer confidence. Besides, the PMI manufacturing index rose for the tenth consecutive month above the threshold of 50 in January (to 57.6 from 55.6 in Dec 09). Meanwhile, improving global credit conditions and a revival in risk appetite have proved particularly favorable for capital inflows and, consequently, for business spending. Furthermore, both real exports and imports posted positive growth on a sequential basis in Q3 09 for the first time since Q3 08, underpinned by the global recovery and strong domestic demand. We forecast India's economy to accelerate to 8% in 2010 from 7% in 2009. In our view, risks to our projections are skewed to both sides and are roughly balanced. On the one hand, an acceleration of reforms could trigger further investment activity. On the other hand, large fiscal imbalances limit the government's ability to support growth by increasing spending. Indeed, the fiscal deficit rose to around 11% of GDP in 2009 from 6.4% of GDP in 2008. As a result, the government should proceed with fiscal consolidation in order to avoid downgrades to its sovereign outlook, and, consequently, a further increase in the cost of financing its debt. Furthermore, rising food and commodity prices put pressures on consumer prices, which in turn would constrain private consumption growth. A sharper-than-expected pick up in inflation would be the key concern of the central bank, which has already hiked the cash reserve ratio by 75bp to drain liquidity from the interbank market.

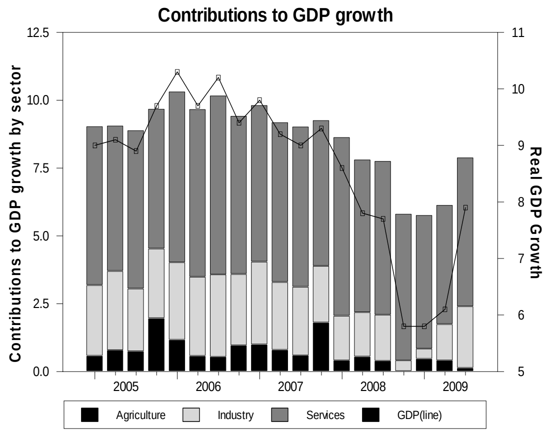
Table 4.2

India Main Economic Indicators and Forecasts

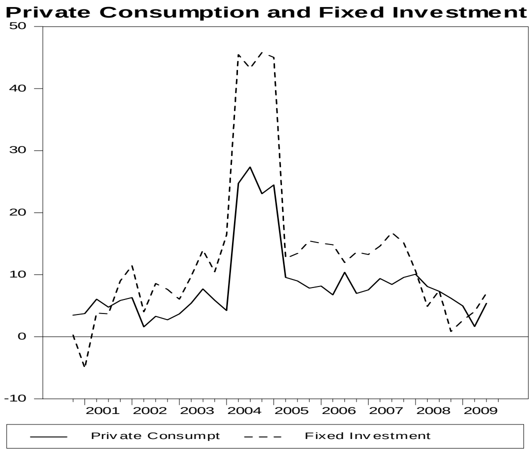
	2008	2009	2010e	2011e
Real GDP (% y-o-y)	7.5	7.0	8.0	8.5
IP** (avg, % y-o-y)	4.5	6.5	7.5	8.0
Inflation (WPI, avg, % y-o-y)	8.4	3.4	6.0	5.5
External Balance				
Real Exports of G & S* (% y-o-y)	12.8	-15.0	10.0	12.0
Real Imports of G & S* (% y-o-y)	17.9	-13.0	10.0	13.0
Trade Balance (% GDP)	-10.0	-7.0	-8.0	-9.0
Current Account (% GDP)	-2.5	-1.5	-2.0	-2.5
Interest Rates	Dec 09	Current	Dec 10	Dec 11
Repo Rate	4.75	4.75	6.25	7.50
Exchange Rates	Dec 09	Current	Dec 10	Dec 11
USD/INR, eop	46.5	46.5	45.0	43.0

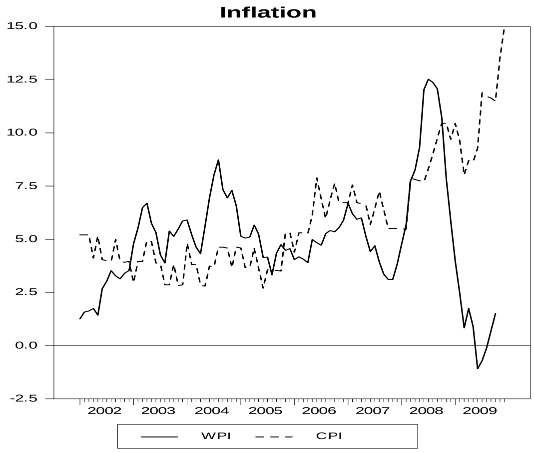
*Goods & Services, **Industrial Production, Source: Eurobank EFG estimates

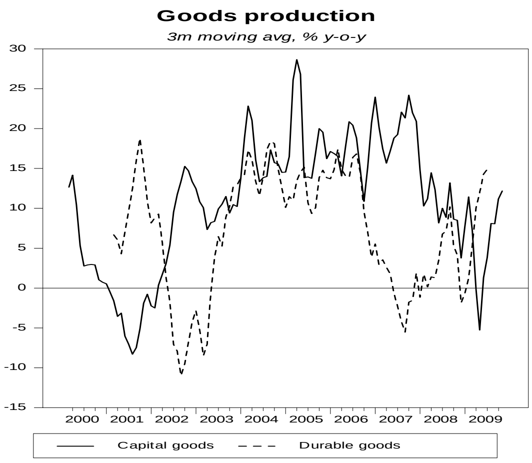
Figure 4.7

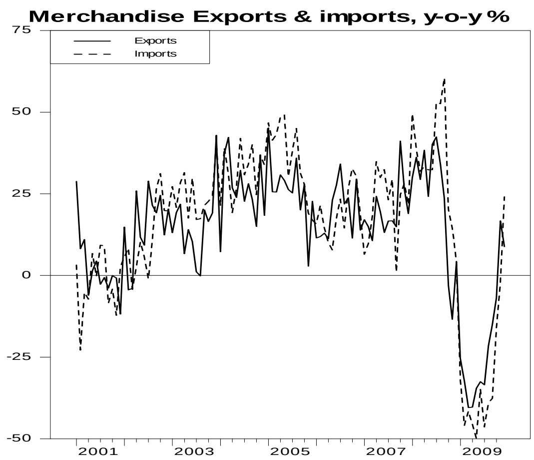


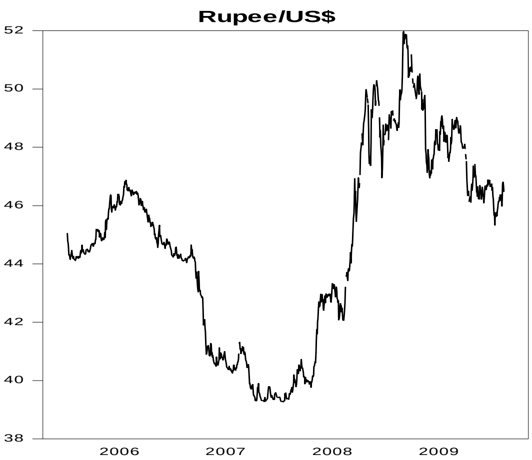
INDIA CHARTS

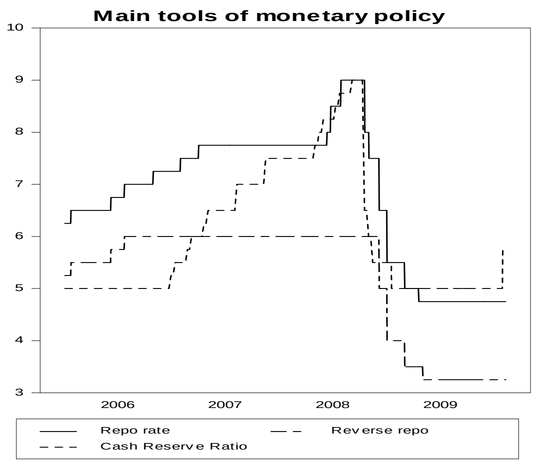












Source: Bloomberg, Ecowin

4.3 Russia Economic Outlook

A combination of a substantial fiscal package, a significant increase in commodity prices and a general improvement in financial and external demand conditions helped output to start rising gradually in the third quarter, suggesting that the Russian economy is already in a recovery phase. We continue to believe that the economic recovery will rely mainly on high commodity prices and strengthening external demand, while weak labor market conditions and subdued bank credit remain an obstacle to Russia's recovery.

According to the official first estimate of 2009 GDP, real GDP contracted by 7.9% (our estimate: -7.5%), compared to consensus estimates of around -8.5%. The contraction is reflected in several economic activity indicators, with the most pronounced slide witnessed in domestic demand, where growth has been dragged down by a collapse in real investment spending. Indeed, fixed capital investment, which is more prone to volatility in an economic downturn, declined by 18.2%, in the wake of higher borrowing costs and tighter domestic liquidity conditions. Inventory adjustment appears also to be a major factor driving GDP downward, as gross capital formation dropped by 37.6%. Household spending, which was growing by over 10% since 2000, fell by 8.1%, as real wages remained in negative territory over almost all 2009 and unemployment jumped to 8.4% from 6.4% in 2008. Meanwhile, the most important driver of the economy in 2009 was net exports that rose by a hefty 58%, reflecting mainly the weakness in domestic demand (real imports plunged by 30.9%), rather than a surge in real exports. Government consumption had also a positive contribution to growth. Indeed, the effect of the government's large fiscal stimulus is expected to spread over H1 2010. Recent monthly economic indicators suggest a gradual stabilization of the industrial sector in response to improved external demand and rising oil prices. Confirming signs of recovery in industrial activity, the PMI manufacturing index moved back into expansionary territory in January (50.8) and the export orders sub index increased sharply, suggesting that external demand is likely to remain a major driver of the recovery in 2010. Apart from export performance, the rebound in oil prices has also triggered a boost in confidence which was accompanied by improving capital flows in Q409. Indeed, capital outflows reduced to $52.4 billion in 2009 from $132.8 billion.

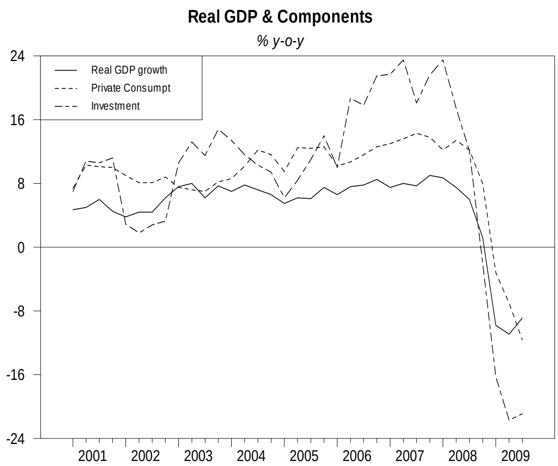
Table 4.3

Russia Main Economic Indicators and Forecasts

	2008	2009	2010e	2011e
Real GDP (% y-o-y)	5.6	-7.9	4.5	5.0
IP** (avg, % y-o-y)	2.6	-10.7	5.0	6.0
Inflation (avg, % y-o-y)	14.1	11.7	6.0	7.0
Unemployment rate (avg, %)	6.4	8.4	8.0	8.0
External Balance				
Real Exports of G & S* (% y-o-y)	0.9	-8.0	6.0	5.0
Real Imports of G & S* (% y-o-y)	15.7	-18.0	5.0	4.0
Trade Balance (% GDP)	10.5	8.0	8.0	6.0
Current Account (% GDP)	6.1	4.5	4.0	3.5
Interest Rates	Dec 09	Current	Dec 10	Dec 11
Refinancing Rate	8.75	8.75	8.50	8.50
Exchange Rates	Dec 09	Current	Dec 10	Dec 11
Exchange Rate (USD/RUB, eop)	30.0	30.2	29.0	28.0

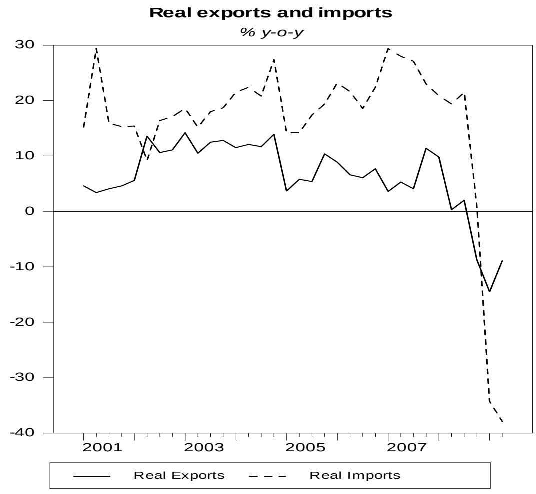
*Goods & Services, **Industrial Production, Source: Eurobank EFG estimates

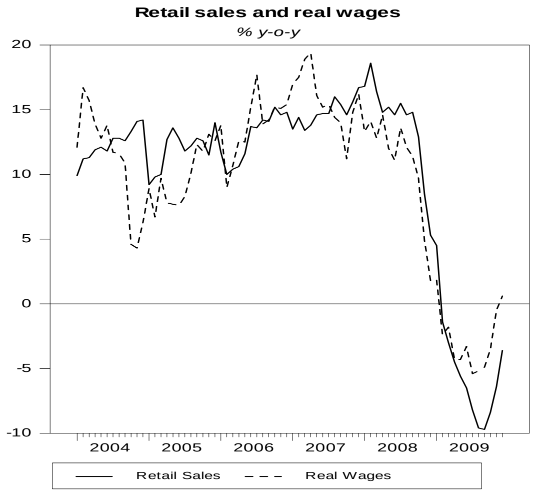
Figure 4.8

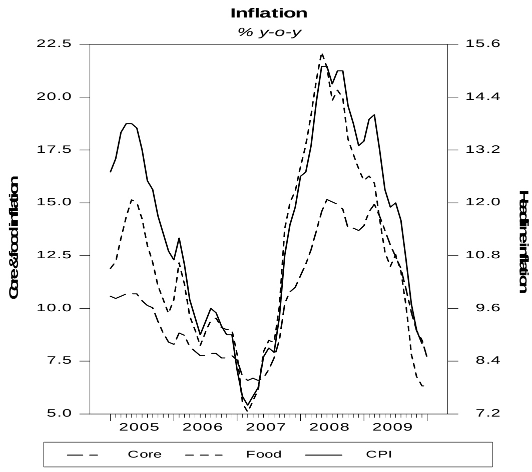


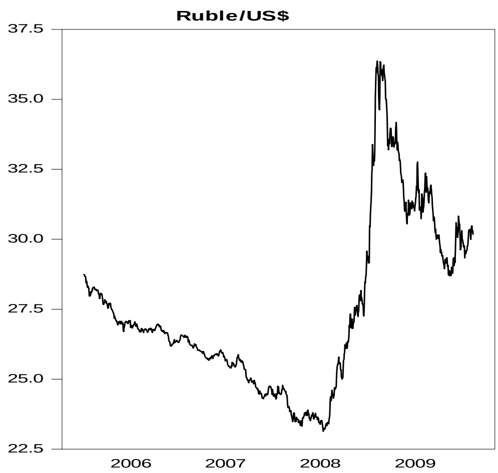
Should this trend continue in the coming months, capital inflows will generate better growth prospects for 2010. In the meantime, inflation fell to its lowest level in the past three years in January. We believe that the weakness of domestic demand will continue to drive inflation down, allowing monetary policy to remain supportive to growth. Nevertheless, although the Russian Central Bank (RCB) has cut the refinancing rate by a total of 450bps since April 2009 (the latest cut, to 8.75% from 9%, took place in December), bank lending has not resumed, restraining households' and corporations' access to credit. With non-performing loans expected to peak in mid-2010, bank lending will remain constrained, acting as a drag on economic growth. We expect the Russian economy to return to positive growth in H1 2010, boosted by the lagged impact of the aggressive fiscal and monetary easing and a sharp inventory rebuilding.

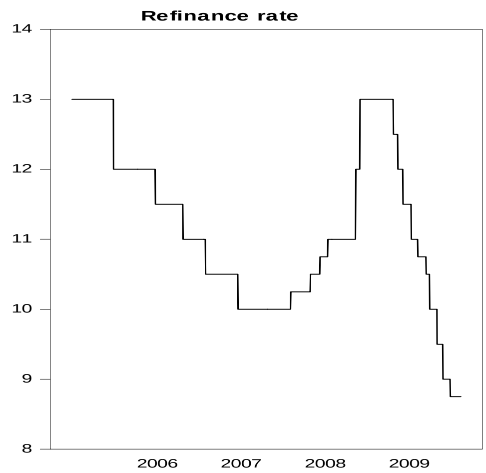
RUSSIA CHARTS











Source: Eurobank EFG, Bloomberg, Ecowin

4.4 Brazil Economic Outlook

Strong macroeconomic fundamentals coupled with effective monetary and fiscal policies have helped the Brazilian economy to recover strongly from a short-lived and mild recession. Amid strong domestic growth perspectives and favorable business and consumer confidence, Brazil's economy is set to gain significant momentum in 2010. Upward pressures to inflation and a widening current account deficit constitute the major challenges for Brazil's upbeat growth outlook.

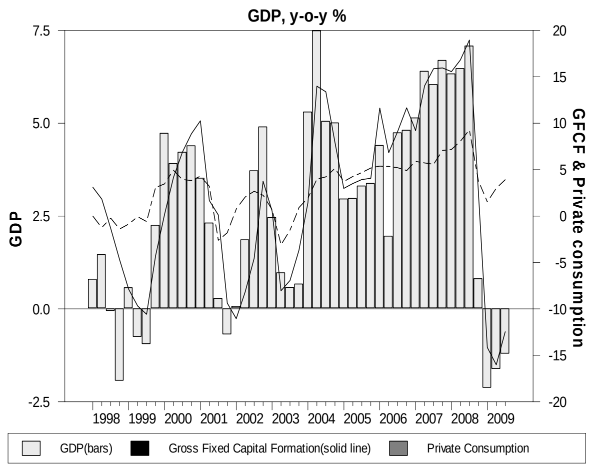
Brazil's economy expanded by a weaker-than-expected 1.3% q-o-q sa in Q3 2009, after an (downwardly revised) increase of 1.1% q-o-q sa in Q1 09. However, we have not altered our upbeat view for Brazil's economic outlook, given that these downward surprises partly reflect methodological changes in measuring GDP. From the demand side, a strong rebound in investment spending (6.5% q-o-q sa from 2% q-o-q sa in Q2 09) was the key factor driving GDP growth, while private consumption lost some steam, increasing by 2.0% q-o-q sa, compared to 2.4% q-o-q sa in the preceding quarter. Meanwhile, labor market conditions remain favorable, albeit they start to show some signs of growth moderation. The rate of unemployment has been brought steadily down to 6.8% in December from its recent peak of 9% in March 2009, mainly due to growing employment. Meanwhile, although net formal job creation came in weaker than expected in December (415k net new jobs were destroyed), the total level for the whole 2009 was still a robust 995k net new jobs. Consumer spending will be also supported by a strong rebound in consumer confidence as reflected by the FGV consumer confidence index, which is in an upward trend since April 2009. A sustainable improvement in household expenditure, coupled with rising capacity utilization, a positive inventory cycle and better global economic conditions should help fixed investment -the largest drag on real GDP growth in 2009- to rebound strongly in 2010. All in, we forecast economic activity to accelerate to 5.5% y-o-y in 2010 from flat growth in 2009. We believe that the risk to this forecast is tilted to the upside, as effective monetary and fiscal policies will continue to have a positive impact on domestic economic activity and credit growth.

Table 4.4
Brazil Main Economic Indicators and Forecasts

	2008	2009	2010e	2010e
Real GDP (% y-o-y)	5.2	0.0	5.5	5.0
IP** (avg, % y-o-y)	2.8	-6.7	8.0	4.0
Inflation (avg, % y-o-y)	5.7	4.9	4.6	4.5
Unemployment rate (avg, %)	7.9	8.1	7.9	7.5
External Balance				
Real Exports of G & S* (% y-o-y)	-0.7	-9.0	6.0	6.0
Real Imports of G & S* (% y-o-y)	18.3	-12.0	12.0	10.0
Trade Balance (% GDP)	1.5	1.6	0.5	0.0
Current Account (% GDP)	-1.7	-1.6	-2.5	-3.5
Interest Rates	Dec 09	Current	Dec 10	Dec 11
Selic rate	8.75	8.75	11.25	11.25
Exchange Rates	Dec 09	Current	Dec 10	Dec 11
Exchange Rate (USD/BRL, eop)	1.7	1.9	1.8	1.8

*Goods & Services, **Industrial Production
Source: Eurobank EFG estimates

Figure 4.9

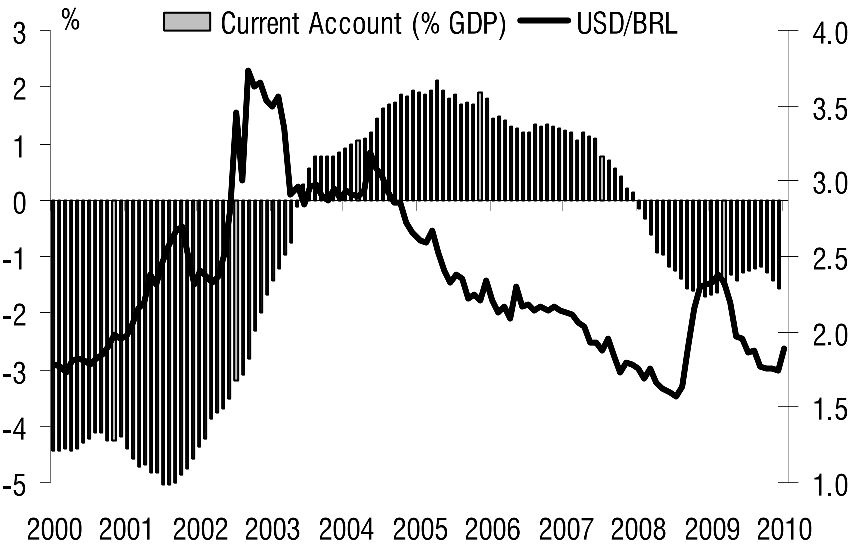


Inflation and a widening current account deficit: the two major challenges for the Brazilian economy

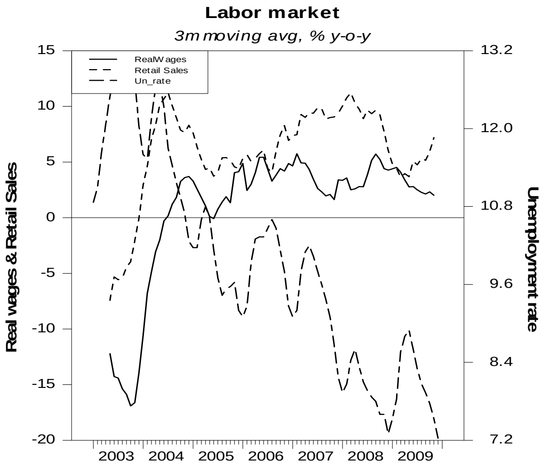
Despite the upbeat growth outlook for Brazil in 2010, we anticipate inflation and a widening current account deficit as two major challenges for the economy. As far as the current account is concerned, robust domestic demand and the appreciation of the BRL, owing to strong capital inflows, will weight on the trade balance. The latter, along with higher profit and dividend remittances, will trigger the widening of the current account deficit to 2.5% of GDP in 2010, from 1.5% of GDP in 2009 (Figure 4.10). Nevertheless, the overall balance of payments is expected to remain favorable, as the increasing risk appetite continues to attract capital inflows and trigger further interest in Brazilian assets.

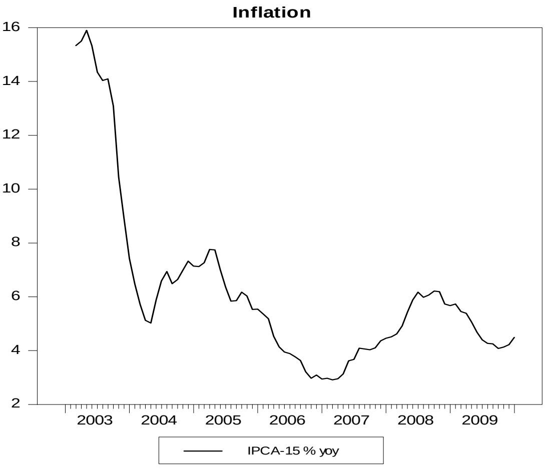
According to the Brazilian's central bank (BCB) quarterly inflation report for Q4 2009, the risks to the inflation outlook are skewed to the upside. Particularly, a stronger-than-anticipated domestic demand growth in 2010, due to expansionary fiscal and monetary policies, could lead to a faster closing of the output gap, adding pressures to inflation. As a result, the BCB is likely to be forced to pave the way for more aggressive interest rate hikes in order to better anchor inflation expectations. We believe that the BCB will start raising benchmark interest rates in H2 2010, after having proceed with a reserve requirements hike, in order to withdraw liquidity from the interbank market.

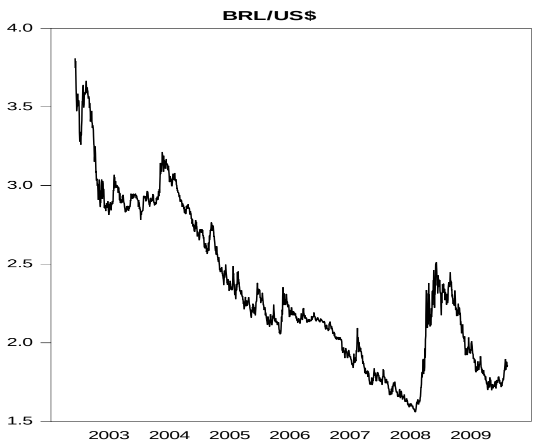
Figure 4.10

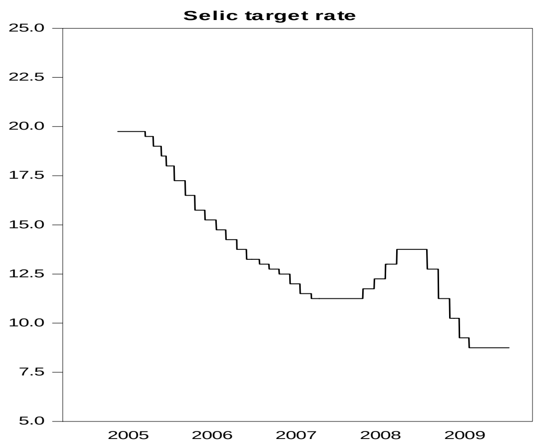


BRAZIL CHARTS







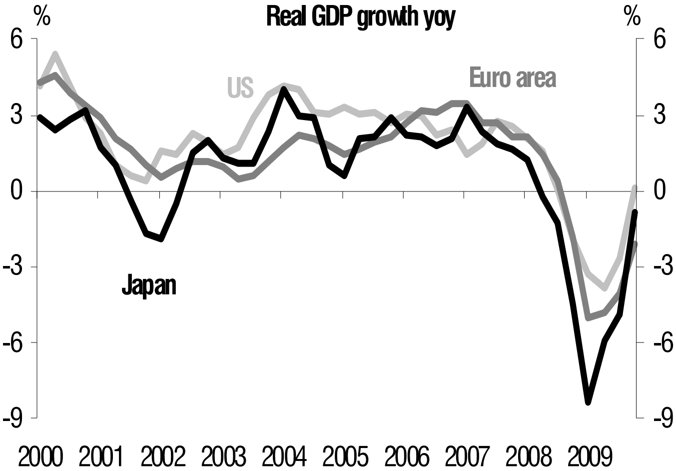


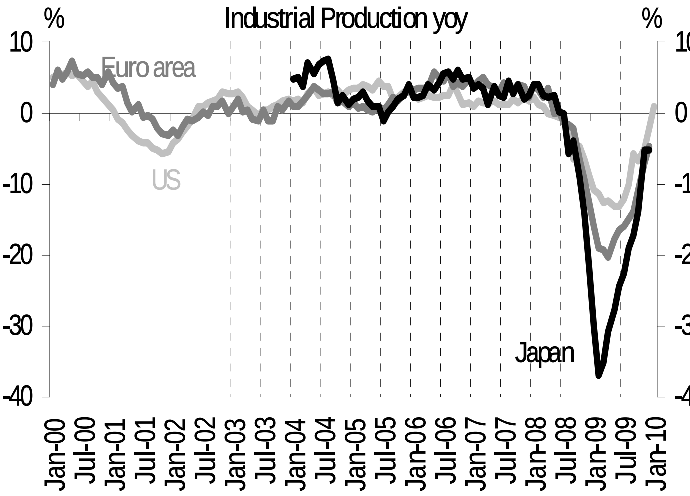
Source: Bloomberg, Ecowin

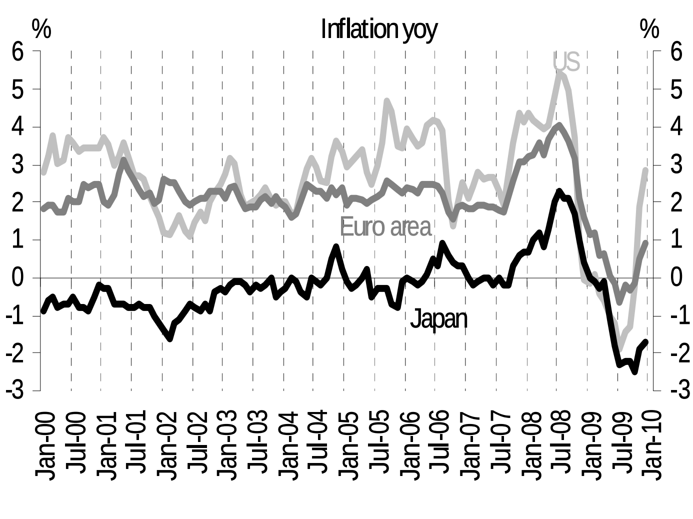
III. GRAPHS

Global Economic Indicators

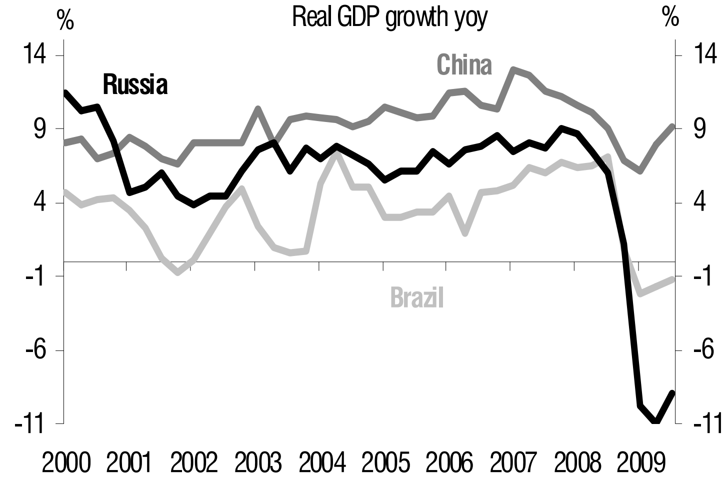
Advanced Economies

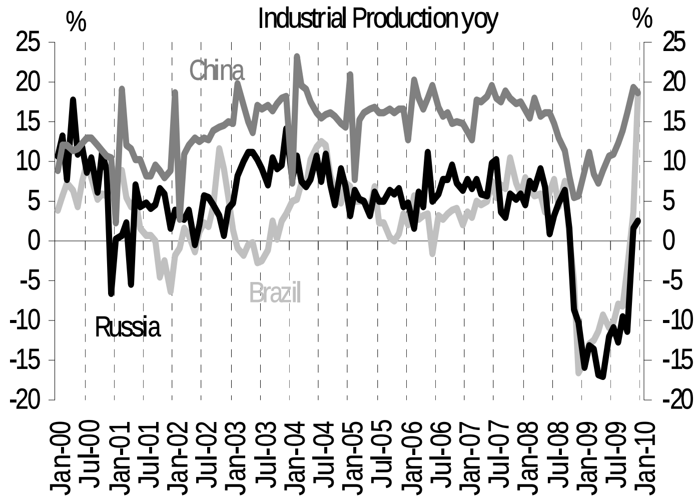


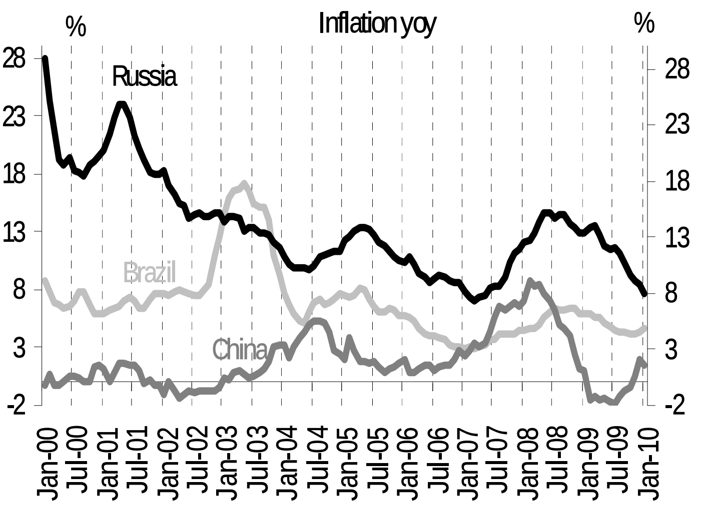




Emerging Economies



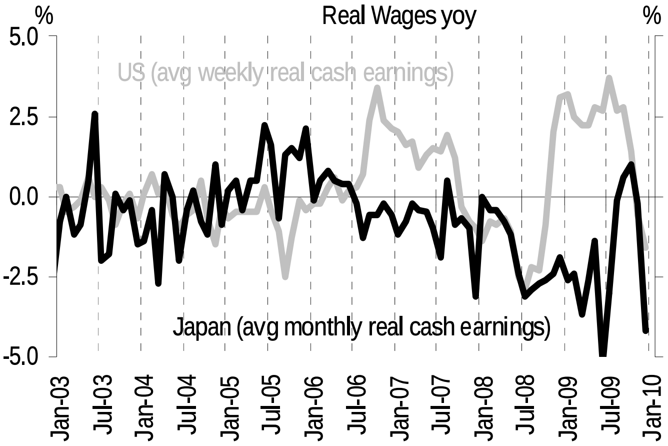




Source: Bloomberg, Ecowin

Global Economic Indicators

Advanced Economies



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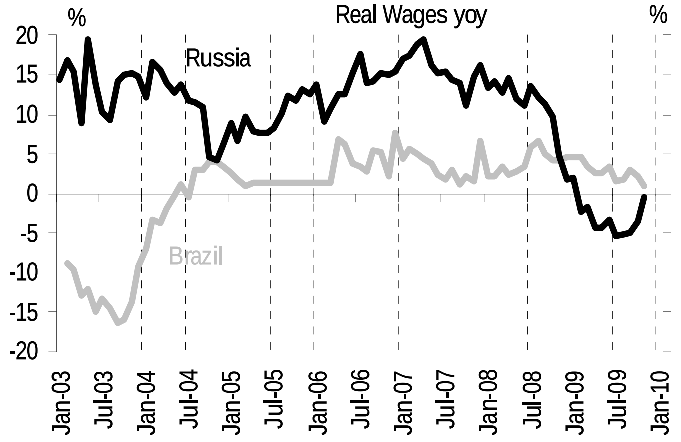
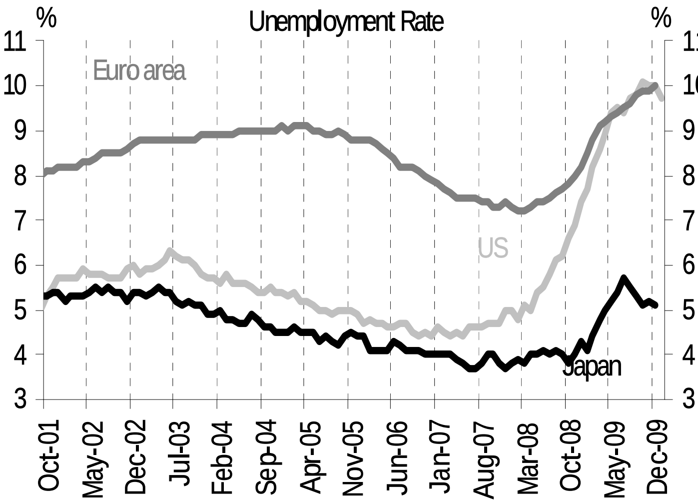
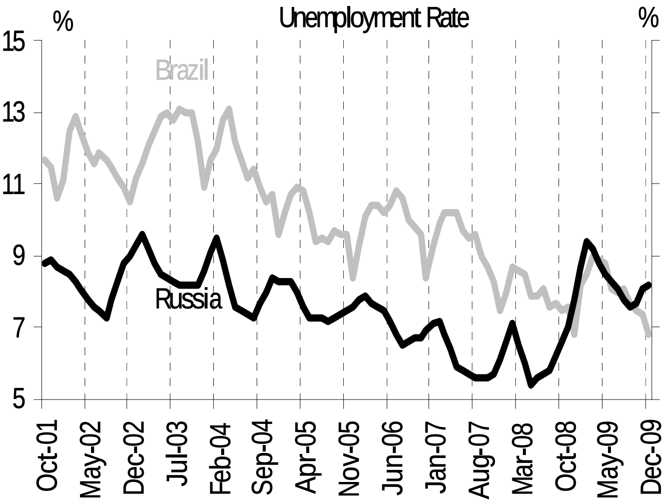
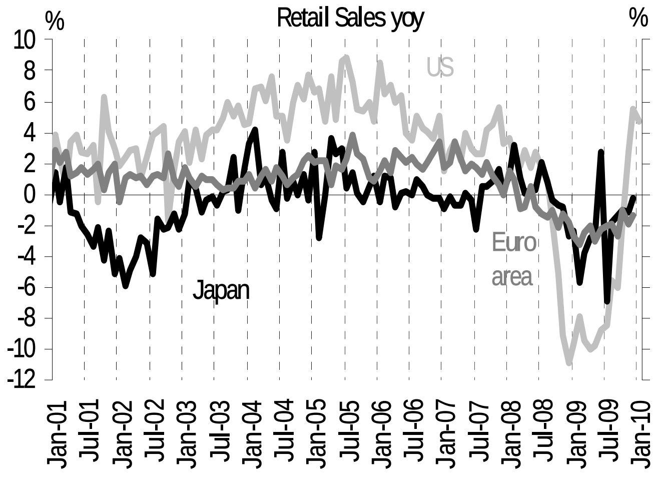
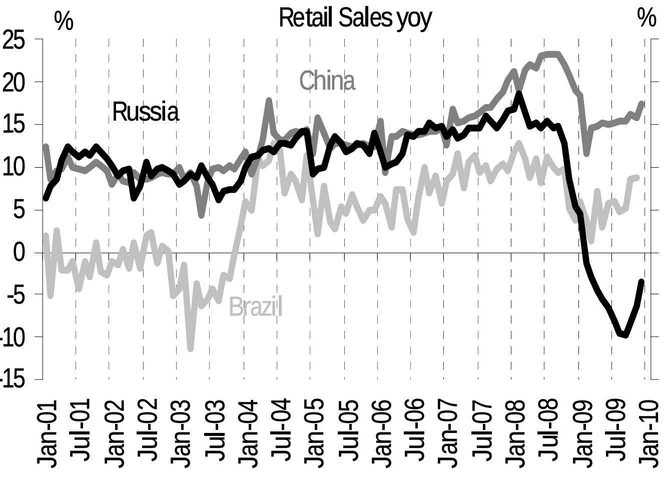






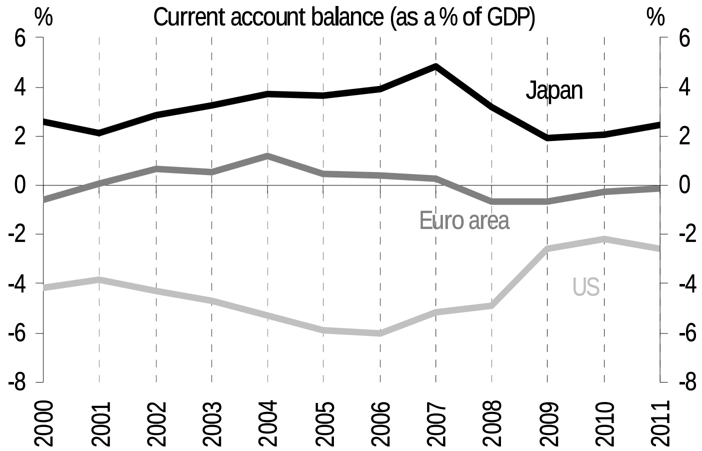




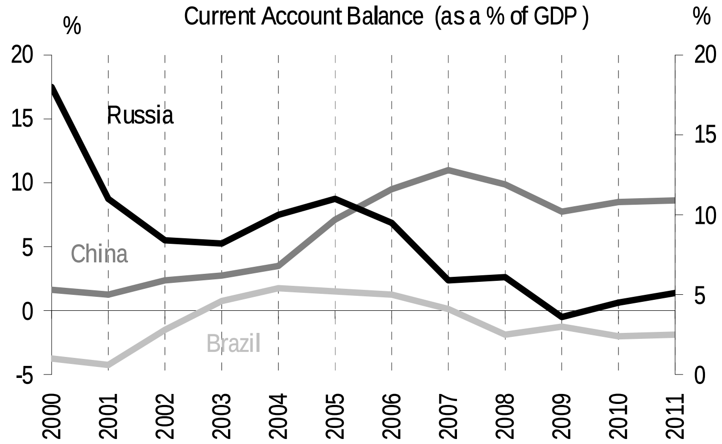
Source: Bloomberg, Ecowin

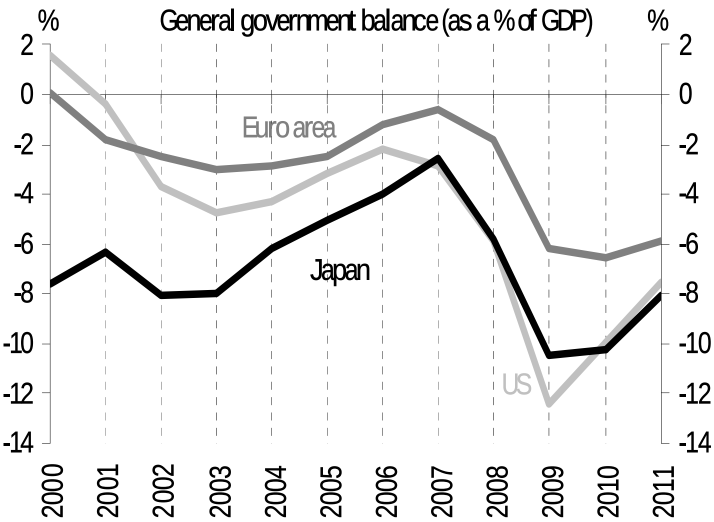
Global Economic Indicators

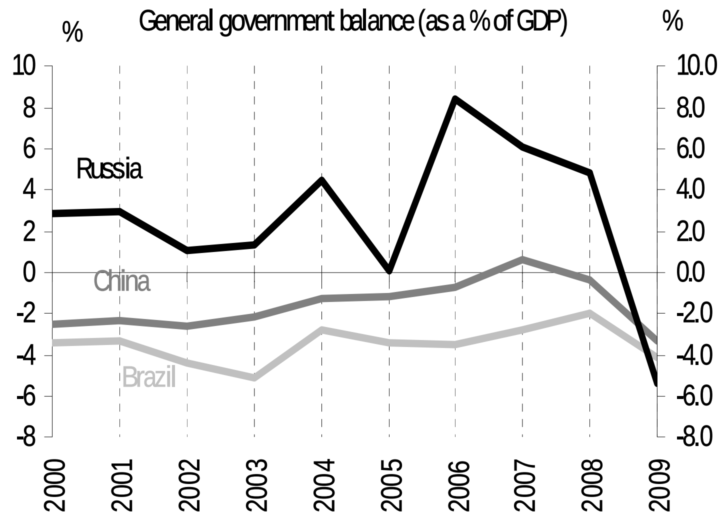
Advanced Economies

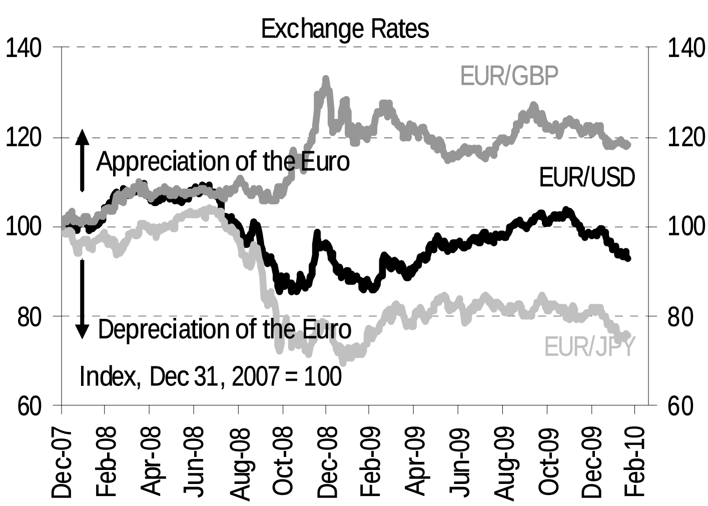


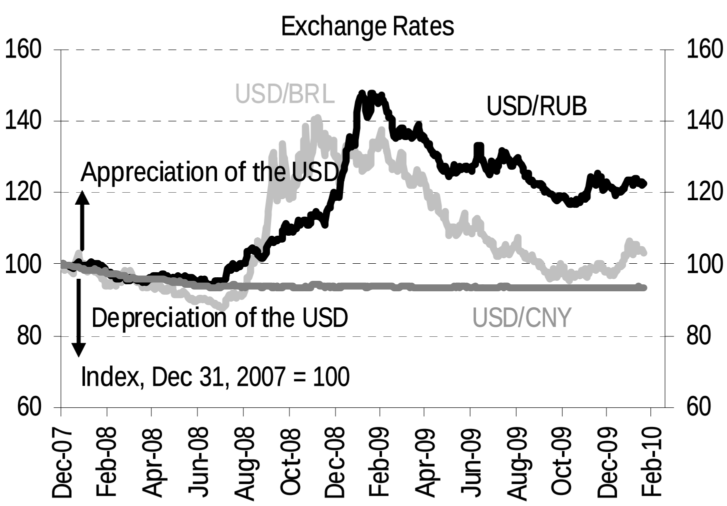
Emerging Economies





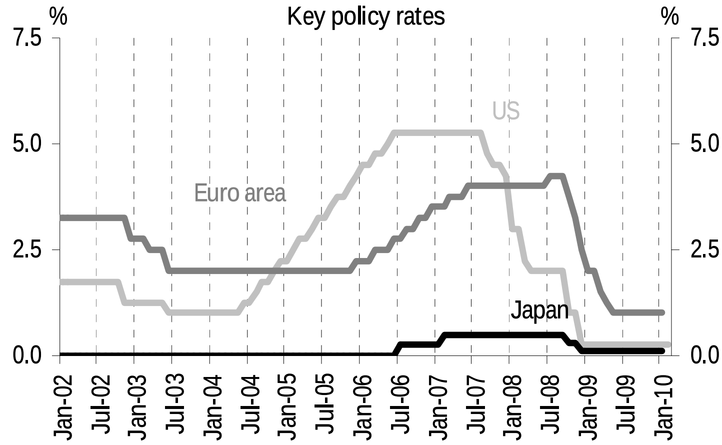


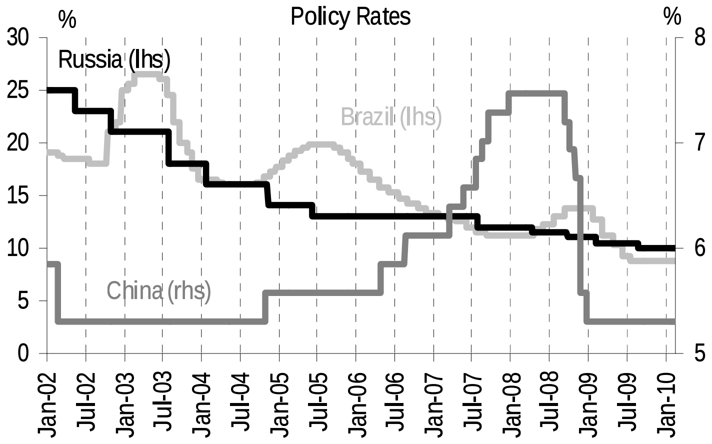




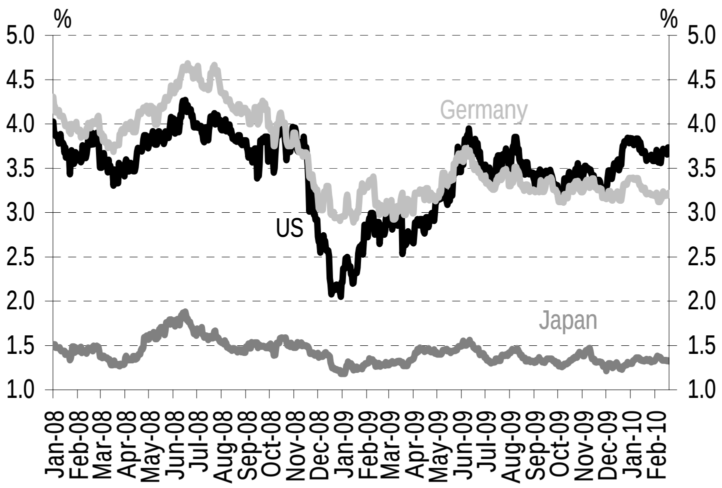
Source: Bloomberg, Ecowin, IMF

Global Economic Indicators

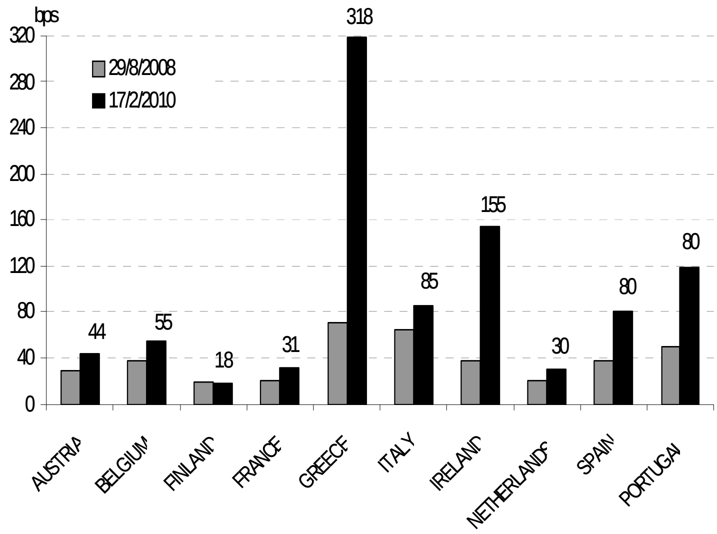




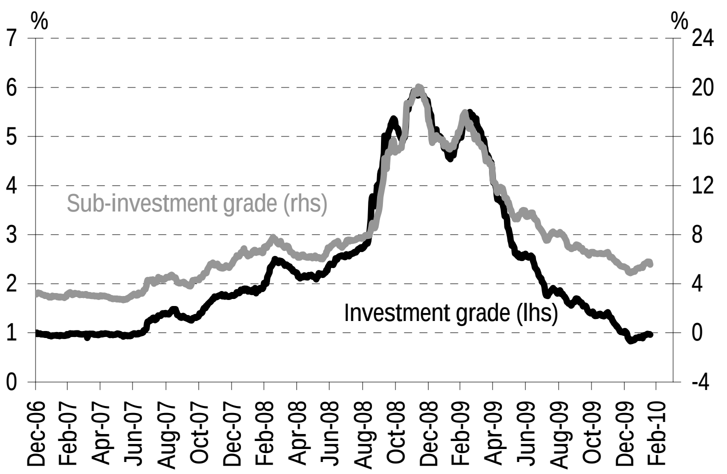
10y Government Bonds



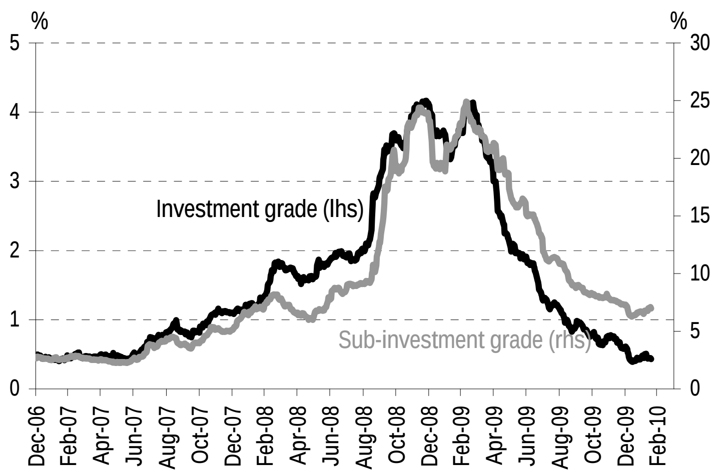
10yr government spreads vs Germany



US Corporate bond yield spreads vs 10-yr government bond



EU Corporate bond yield spreads vs 10-yr government bond



Source: Bloomberg, Ecowin

Global Equities & Sector Performance

Total Return (%) as of February 17, 2010

Global Equity Indices (in local currency)

Region	Index	Last Price	1w	1m	6m	12m	YTD	2009
US	S&P 500	1099.5	2.7	-3.2	11.1	39.5	-1.4	23.5
EURO AREA	DJ Euro Stoxx 50	2762.3	3.1	-6.6	5.0	30.4	-6.8	21.1
GERMANY	DAX	5648.3	2.6	-4.6	7.6	34.3	-5.2	23.8
FRANCE	CAC 40	3725.2	3.0	-6.3	8.0	29.6	-5.4	22.3
UK	FTSE 100	5276.6	2.2	-4.0	12.6	31.7	-2.5	22.1
JAPAN	Nikkei	10306.8	3.4	-5.1	0.2	36.8	-2.3	19.0
CHINA	CSI 300	3251.3	3.1	-6.6	-2.8	35.5	-9.1	96.7
INDIA	SENSEX	16428.9	3.2	-6.9	9.3	82.2	-5.9	81.0
RUSSIA	MICEX	1354.1	1.9	-8.5	30.8	115.6	-1.2	121.1
BRAZIL	IBOV	67284.6	6.5	-3.0	20.7	69.6	-1.9	82.7

Source: Bloomberg

Sector performance as of February 17, 2010

US Sector Indices (in USD)

US – S&P 500	Last	1w	1m	6m	12m	YTD	2009
1. Consumer Discretionary	282.6	2.3	-1.0	19.8	65.9	-0.3	41.3
2. Consumer Staples	384.1	1.7	-0.3	12.7	29.7	0.8	14.9
3. Energy	607.3	3.4	-3.9	14.6	25.2	-0.6	13.8
4. Financials	272.3	3.3	-4.7	5.2	83.1	-1.0	17.2
5. Health Care	458.4	0.8	-3.5	12.9	21.0	-0.1	19.7
6. Industrials	327.4	2.8	-3.0	19.3	49.4	1.6	20.9
7. Information Technology	378.7	2.5	-4.7	15.0	56.3	-4.9	61.7
8. Materials	269.2	3.4	-5.8	12.3	57.7	-3.8	48.6
9. Telecommunication Services	168.2	0.5	-3.1	4.5	17.0	-8.2	8.9
10 Utilities	277.3	1.4	-5.2	4.5	13.7	-5.6	11.9

Source: Bloomberg, Ecowin

Global Equities & Sector Performance

Sector performance as of February 17, 2010

European Sector Indices (in €)

Europe - DJ Stoxx 600	Last	1w	1m	6m	12m	YTD	2009
1. Consumer Discretionary							
Automobiles & Components	307.1	1.4	-13.3	-7.5	21.6	-10.1	19.4
Travel & Leisure	174.2	2.6	0.4	17.0	28.9	4.0	18.5
Media	234.8	2.2	-3.3	13.1	25.5	-2.3	23.4
Retail	400.9	1.4	-0.1	11.9	36.5	1.9	37.4
2. Consumer Staples							
Food & Beverage	479.8	2.5	0.9	21.7	46.9	0.9	35.2
Personal & Household Goods	542.5	0.8	-0.1	19.9	47.3	3.6	42.0
3. Energy							
Oil & Gas	588.9	1.9	-5.5	12.2	22.3	-2.4	29.9
4. Financials							
Banks	379.2	3.8	-8.9	-5.5	80.9	-6.9	50.7
Financial Services	376.9	3.2	-6.3	1.3	42.1	-6.0	33.6
Insurance	231.5	4.2	-3.7	6.6	47.8	-1.9	17.0
Real Estate	101.9	2.5	-2.9	5.4	43.1	-3.3	27.0
5. Health Care	525.3	1.6	1.0	15.4	21.0	2.7	16.8
6. Industrials							
Industrial Goods & Services	374.6	1.8	-3.2	15.0	46.3	-0.1	41.2
7. Information Technology	192.4	2.7	0.1	10.6	28.0	4.2	20.5
8. Materials							
Basic Resources	835.8	4.3	-7.4	30.6	93.4	-2.5	105.9
Chemicals	742.7	3.3	-2.1	20.8	48.0	-3.6	48.7
Construction & Materials	413.5	2.1	-8.8	8.4	46.5	-6.5	39.9
9. Telecommunication Services	428.0	1.7	-2.1	7.1	19.7	-4.9	17.5
10. Utilities	623.5	2.4	-4.3	5.3	14.3	-5.3	6.2

Source: Bloomberg

Sector performance as of February 17, 2010

Asia Sector Indices (in USD)

Asia – S&P 50 Index*	Last	1w	1m	6m	12m	YTD	2009
1. Consumer Discretionary	7992.8	3.7	2.6	16.1	117.3	0.2	116.2
2. Consumer Staples	13243.8	1.6	-4.9	7.0	64.4	2.3	47.6
3. Energy	9426.3	3.1	-3.5	13.6	67.8	-3.1	58.0
4. Financials	3297.0	3.0	-4.9	7.1	-4.2	-8.1	69.1
5. Industrials	1994.5	5.5	-1.3	12.5	61.9	10.0	32.5
6. Information Technology	7393.1	2.1	-10.2	15.3	87.0	-5.9	91.4
7. Materials	4258.5	2.2	-7.8	23.0	86.8	-5.0	72.7
8. Telecommunication Services	2388.6	1.6	-1.5	-5.0	13.4	1.9	-0.2
9. Utilities	2936.1	3.4	-0.5	11.5	36.0	1.8	25.3

Source: Ecowin

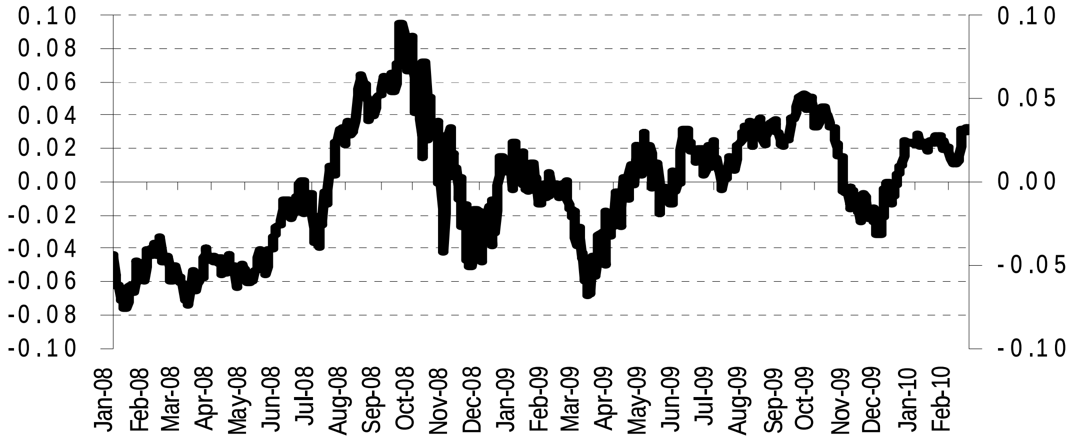
US Style Equity Indices

Total Return (%) as of February 17, 2010

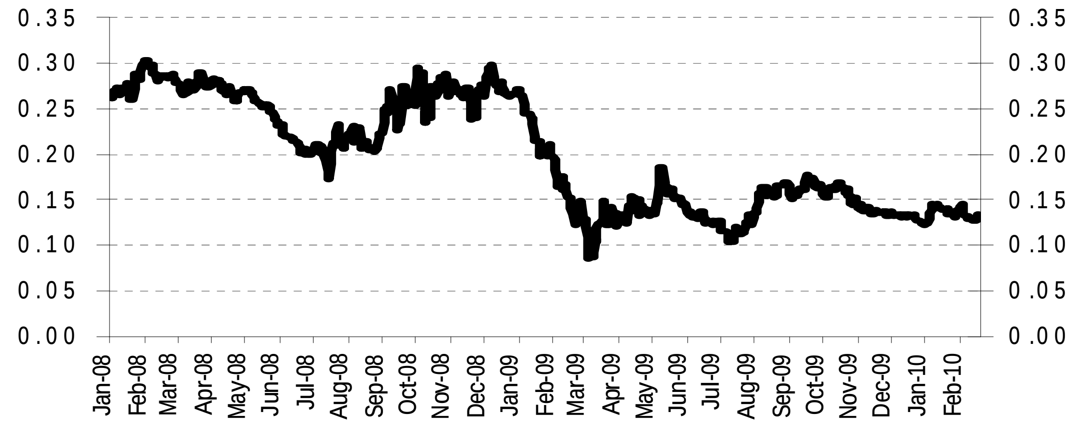
US Style Indices (in USD)

Index	Last Price	1w	1m	6m	12m	YTD	2009
Russell 1000 (Large Cap)	605.0	2.9	-3.0	11.7	41.4	-1.1	25.5
Russell 2000 (Small Cap)	624.8	5.0	-2.1	12.3	47.7	-0.1	25.2
Relative performance (Small vs Large)		2.0	0.9	0.6	6.2	1.1	-0.3
Russell 1000 Value	561.8	3.0	-3.4	10.4	41.2	-0.8	16.3
Russell 1000 Growth	492.8	2.9	-2.6	13.0	41.6	-1.5	34.8
Relative performance (Value vs Growth)		0.2	-0.8	-2.6	-0.5	0.7	-18.5

Relative Performance (small vs large)
(logarithmic scale)



Relative Performance (value vs growth)
(logarithmic scale)



Source: Bloomberg

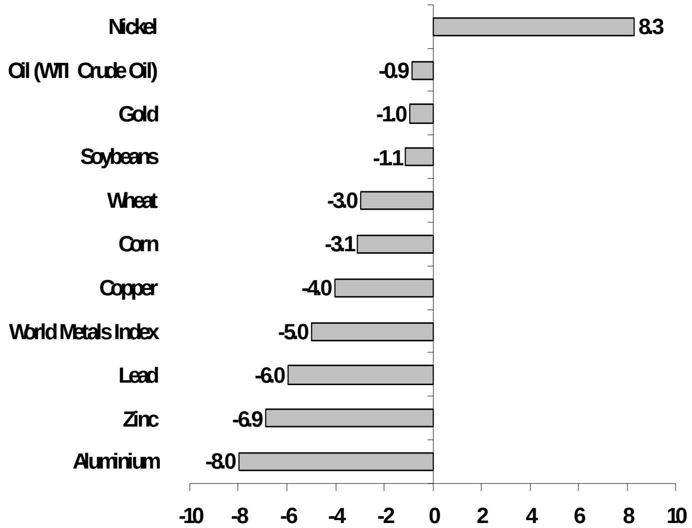
Commodities

Commodity Performance (%) as of February 17, 2010

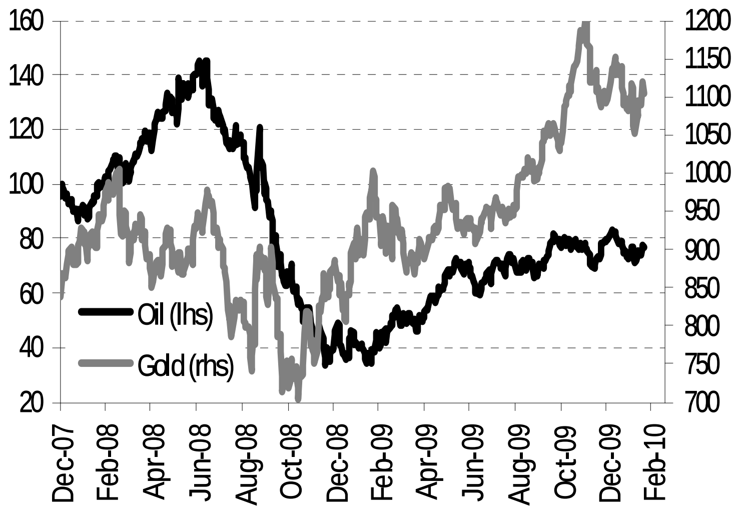
Commodities

	Units	Last Price	1w	1m	6m	12m	YTD	2009
Oil (WTI Crude Oil)	USD/bbl	77.3	3.8	-0.9	11.8	123.4	-2.6	77.9
Gold	USD/t oz	1119.5	4.1	-1.0	19.4	14.5	2.1	24.0
Base Metals								
World Metals Index		3296.7	3.8	-5.0	14.7	98.6	-3.1	97.5
Aluminium	USD/lb	2122.0	4.3	-8.0	8.3	59.5	-4.8	44.8
Copper	USD/mt	7130.0	9.1	-4.0	17.9	123.9	-3.3	140.2
Lead	USD/mt	2290.0	12.0	-6.0	28.3	106.5	-5.8	143.4
Nickel	USD/mt	20140.0	13.7	8.3	5.4	103.4	8.7	58.3
Zinc	USD/mt	2300.0	8.8	-6.9	29.9	107.2	-10.2	111.9
Agriculture								
Corn	USD/bu	360.0	-0.5	-3.1	14.5	3.1	-13.1	1.8
Soybeans	USD/bu	931.8	1.8	-1.1	0.0	8.4	-8.1	-0.3
Wheat	USD/bu	494.8	-0.4	-3.0	5.2	-3.1	-8.6	-11.3

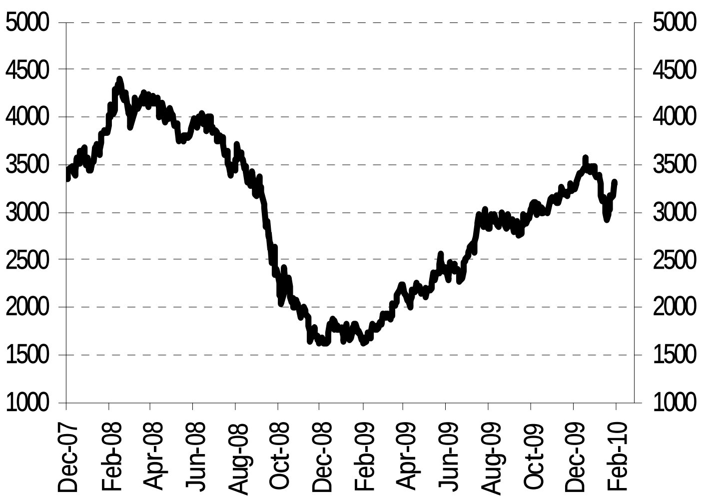
1-Month Return



Oil & Gold



World Metals Index



Source: Bloomberg

Eurobank EFG

A few words about EFG Eurobank Ergasias S.A. (Eurobank EFG)

EFG Eurobank Ergasias S.A. (Eurobank EFG), is the second largest bank in Greece with assets of around €45 billion. Founded in 1990, Eurobank EFG has received high marks from the most reputable international rating agencies (Standard & Poor's, Fitch and Moody's), not only for its financial strength, but also, for the Group's client focus, high level of services, its heavy investment in modern technologies and its professional and dynamic management and personnel. As a member of EFG Group – a Geneva-based banking Group – it has access to all European financial markets.

Eurobank EFG offers a comprehensive array of banking products and services for individuals, corporations and institutions. It currently employs more than 23,700 people in Greece and abroad and runs a distribution network of over 1,550 branches and alternative distribution channels. In recent years, the Bank has expanded into Bulgaria, Romania, Serbia, Turkey, Polan, Ukraine, Luxemburg, United Kingdom and Cyprus.

More information about Eurobank EFG can be found at http://www.eurobank.gr

More research by Eurobank EFG's Division of Economic Research & Forecasting can be found at http://www.eurobank.gr/research

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